United States General Accounting Office

GAO

Report to Congressional Committees

October 1989

# TAX POLICY

# Allocation of Taxes Within the Life Insurance Industry

GAO/GGD-90-19

GAO
**United States**
**General Accounting Office**
**Washington, D.C. 20548**

**General Government Division**

B-233706

October 19, 1989

The Honorable Fortney H. (Pete) Stark
Chairman, Subcommittee on Health
Committee on Ways and Means
House of Representatives

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select
Revenue Measures
Committee on Ways and Means
House of Representatives

This report completes our response to your request for information on the stock and mutual segments of the life insurance industry. It analyzes section 809 of the Internal Revenue Code and makes recommendations for adjusting life insurance taxation.

We are sending copies of this report to the Secretary of the Treasury as well as to appropriate congressional committees and other interested parties. We will send copies to others upon request.

Please contact me at 275-6407 if you or your staff members have any questions concerning the report. Other major contributors to this report are listed in appendix VIII.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

## Results in Brief

Section 809 taxes follow a pattern not normally associated with income taxes. GAO found that these taxes

- were higher for the mutual companies as a whole in years when their earnings were low, and vice versa;
- were regressive on the basis of company income because segmentwide averages dictated each company's taxes; and
- depended disproportionately on the behavior and performance of the larger mutual companies.

GAO considered alternative methods for taxing mutual companies and believes one approach offers particular advantages. Under it, mutuals could deduct dividends in calculating the company's income tax, but individual policyholders would owe tax on the portion of dividends that are a distribution of earnings, as stockholders do. To eliminate the complex calculations that mutuals must make each year, as well as to reduce the inequitable results of section 809, Congress would designate the portion of dividends to be treated as distributed income. However, to simplify computing and collecting these taxes, GAO's approach would have the companies pay the tax as a "proxy" for the policyholders.

## GAO's Analysis

### Concerns About Section 809

Section 809 imposes a tax that is regressive both year to year and company by company. When mutual companies do well in a particular year, the average mutual earnings rate is high, and the differential earnings rate and resulting taxes are low. When the segment does poorly, the differential taxes are high. (See pp. 24-25.) By the same token, when a particular company does better than the average mutual in a given tax year, its differential taxes are a smaller proportion of its total taxes than is the case for the average mutual. If the company does worse than average, these extra taxes are a larger proportion of total taxes. This is because of the way the differential earnings rate—the difference between the imputed and average mutual earnings rate—is calculated and applied to all firms regardless of their earnings that year. (See pp. 21-24.)

Another concern with section 809 is that each mutual company's taxes depend disproportionately on the behavior and performance of the larger mutuals. The average mutual earnings rate used in section 809 is

for their policyholders. This approach would be simpler to calculate and would involve collecting the tax from thousands of companies rather than from millions of individuals. The mutual companies favor this approach because the tax would be less visible to the policyholder and it would be harder to distinguish "taxed" from "untaxed" products. (See pp. 59-62.)

## Recommendations

GAO recommends that Congress delete section 809 from the tax code and designate what portion of policyholder dividends paid by life insurance companies consists of distributed earnings. For administrative reasons, companies would pay the tax as a proxy for individual policyholders. (See p. 65.)

## Agency Comments

GAO received a mix of favorable and unfavorable comments on its draft report from the Department of the Treasury as well as from various parties within the insurance industry. Treasury noted that it had reported to Congress significant practical and conceptual shortcomings of section 809 and recommended its repeal. However, Treasury's preferred remedy differed from GAO's in that it recommended a tax on the investment income of stock and mutual companies rather than on policyholder dividends.

The comments from the stock and mutual companies reflected their long-held policy positions. The stock companies stated that GAO's recommendations were unreasonable and extremely unfair to stock life insurance companies. The mutual companies found GAO's study to be thorough and impartial, said that mutual companies support most of GAO's major findings, and suggested refinements in GAO's recommendation for a proxy tax. Each of the groups suggested some technical changes. These were incorporated in GAO's report, where appropriate. The comments and GAO's responses are on pages 15 to 16, 35 to 36, and 65 to 71. Copies of the letters received from each organization are in appendixes III through VII.

**Abbreviations**

JCT Joint Committee on Taxation

The taxation of mutual insurance companies, however, presents a problem. Like stock companies, they include as income the increase in their surplus (similar to corporate retained earnings). However, the dividends mutuals pay differ from those that stock companies pay to their stockholders. Mutuals pay dividends to their policyholders who are both customers and owners of the company. Mutuals do not have stockholders. The questions then are: to what extent should a mutual company consider these dividends a part of its taxable income and to what extent should it be allowed to deduct them?

Answering these questions requires some understanding of the primary product sold by mutual companies—the participating life insurance policy. The participating policy differs from the nonparticipating policy (the predominant form sold by stock life companies) in that the premiums charged are larger for the same insurance coverage. The premiums include one part that pays for insurance and a second part (called the excess premium) that can be looked upon as a contribution of capital to the company.

In return for the higher premiums, participating policies offer a stream of dividends to policyholders. These dividends depend, in part, on the company's performance and are expected to reduce the net cost of the policy. The dividends can include as many as five components: price reductions, interest payments, repayment of capital, capital gains, and dividend income.

Under the corporate income tax laws, the five components of dividends paid out by mutuals are handled in different ways. First, price reductions and interest payments are subtracted from gross revenue in determining taxable income. Second, equity contributions to shareholder-owned corporations do not enter the corporate tax base when they are paid in, and are not deductible from that base if they are paid out to shareholders.[2] Finally, dividend income and possibly some capital gains make up the return on equity portion of policyholder dividends, which is a form of earnings distribution and therefore part of taxable income. For mutuals, this portion represents the equivalent of that part of a stock company's income that is paid out in shareholder dividends. The difficulty comes in disentangling these five components of policyholder dividends and determining which parts should be considered the return on equity and therefore taxable.

[2]Whether equity contributions enter the tax base for a mutual company is the subject of some debate. The issue will be discussed in chapter 3.

average of the year-end equities from this year and last). In other words, the average mutual earnings rate is a weighted average of the rates of return for all mutual companies in which the weights are each company's proportion of the equity of the whole mutual segment.

Since the imputed rate is a measure of the return on equity for the mutuals, including what is distributed and what is not, and since the average mutual earnings rate measures the part of earnings that is not distributed, the differential earnings rate is a measure of the part of the rate of return on equity that is paid out in policyholder dividends by the average mutual firm.

This rate is multiplied by each firm's mean equity to calculate the "differential earnings amount" because Congress thought that companies distribute earnings in proportion to their equity. This differential earnings amount is a dollar value that approximates how much the firm distributed in earnings to its owners, the policyholders. The policyholder dividend deduction is reduced by this amount, which has the effect of increasing the taxable income of each mutual.

The information required to calculate the average mutual earnings rate is not available when mutual companies compute their taxes; thus, the law requires an initial computation and then a recomputation in the following tax year. The initial computation uses a mutual earnings rate that is 2 years old, while the recomputation uses the actual average mutual earnings rate for the relevant tax year.

The main purpose of Section 809 is to address the issue of taxing the earnings part of policyholder dividends at the company level. A secondary purpose is to address the issue of taxing these earnings at the individual level. Earnings distributed to shareholders are subject to the personal income tax. Currently, the personal income tax does not apply to the earnings component of policyholder dividends until the sum of those dividends is greater than the sum of premiums paid into the policy, or when the policy is surrendered.

**Table 1.1: Taxes Incurred by the Life Insurance Industry, 1984-87**

Dollars in Billions

| | Treasury reports[a] | | GAO study | |
|---|---|---|---|---|
| **1984** | **Amount[b]** | **Percent** | **Amount[b]** | **Percent** |
| Stock | $1.8 | 62 | $1.5 | 56 |
| Mutual | 1.1 | 38 | 1.2 | 44 |
| **Total** | **2.8** | **100** | **2.8** | **100** |
| **1985** | | | | |
| Stock | 2.2 | 61 | 2.1 | 51 |
| Mutual | 1.5 | 39 | 2.0 | 49 |
| **Total** | **3.6** | **100** | **4.1** | **100** |
| **1986** | | | | |
| Stock | 1.9 | 49 | 2.3 | 49 |
| Mutual | 2.0 | 51 | 2.4 | 51 |
| **Total** | **3.9** | **100** | **4.7** | **100** |
| **1987[d]** | | | | |
| Stock | (c) | (c) | 1.5 | 79 |
| Mutual | (c) | (c) | .4 | 21 |
| **Total** | **(c)** | **(c)** | **1.8** | **100** |
| **1984-87** | | | | |
| Stock | 5.9[c] | 56[c] | 7.4 | 55 |
| Mutual | 4.6 | 44 | 6.0 | 45 |
| **Total** | **10.3** | **100** | **13.4** | **100** |

[a]Both Treasury reports show taxes for life insurance companies or groups before and after consolidation with related non-life companies. The figures in this table are before consolidation.

[b]May not add due to rounding.

[c]The Treasury Studies' tax return figures do not include 1987.

[d]These figures were not included in the GAO fact sheet.

Source: Final Report to Congress on Life Insurance Company Taxation, Department of the Treasury and Tax Policy: Information on the Stock and Mutual Segments of the Life Insurance Industry (GAO/GGD-88-88FS, Sept. 26, 1988).

## Objectives, Scope, and Methodology

Even though the data indicate that the expected 55-45 mutual-stock split was not achieved, the section 809 mechanism may still have achieved segment balance. An alternative way to evaluate segment balance would be to see if the mutual-stock split in taxes was consistent with the mutual-stock split in income. Thus, one of our objectives was to assess whether this occurred.

Even if segment balance is being achieved overall, problems may arise year to year or firm by firm. Our second objective, therefore, was to analyze the effects of the section 809 procedure on the taxes of the life

1986. Appendix II contains more details on how we gathered the information for individual companies.

In chapter 3, we discuss particular alternatives to section 809 that appear often in the life insurance and taxation literature. They also span a continuum of possibilities from a very wide to a very narrow definition of taxable income for mutuals. We based our calculations of the revenue implications of the different alternatives on the segmentwide measures of earnings rates and equity discussed above.

The Department of Treasury, the Stock Company Information Group, the National Association of Life Companies, the Mutual Life Insurance Company Tax Committee, and State Farm Mutual Automobile Insurance Company provided written comments on a draft of the report. Relevant portions of their comments are presented and evaluated at the end of each chapter. The comment letters are reprinted as appendixes III through VII, respectively.

We did our work in accordance with generally accepted government auditing standards from June 1987 through October 1988.

## Treasury and Industry Comments and Our Evaluation

Both Treasury and the two stock company groups disagree with our measures of taxes incurred by the life insurance industry and the two segments because we use financial statement information, which they believe is biased upwards.

Although financial statements may not give an exact measure of taxes received by the government in any given year, we believe that the estimated taxes calculated from them need not be biased upwards. Statements should, over a long enough period, give a measure of taxes that is consistent with tax returns. We chose to use financial statements rather than actual tax returns because the statements were available on a more timely basis. Treasury also used financial statement taxes in its report to give an indication of taxes for 1987 and 1988, since it did not have tax data for those years.

Treasury and the mutual companies believe we should have accounted for consolidation of life insurance companies with non-life affiliates to measure the revenue received by the government. The stock groups think that our treatment is appropriate.

# Section 809 Provisions Raise Questions and Concerns

While much of the public debate over section 809 has concerned the amount of tax revenue being generated by the life insurance industry or the split in taxes between the stock and mutual segments, there is a more important question about section 809. Is it achieving its purpose? The section's purpose follows from the stated goal of the life insurance company tax provisions of the Deficit Reduction Act of 1984, which is to tax those companies in a manner that bears a close resemblance to the general structure of corporate income taxation.[1] This purpose is to (1) measure, as accurately as possible, the part of policyholder dividends that constitutes a distribution of earnings by the mutual companies; and (2) tax this distribution of earnings regardless of the mutual-stock split in tax revenue that results.

As shown in chapter 1, section 809 did not generate the revenue expected for 1984. For 1985 and 1986, revenues were greater than expected, although this was largely the result of extensive capital gains realizations. In 1987, tax revenues were substantially less than originally projected. A 55-45 mutual-stock split was not achieved during any of the 4 years.

In this chapter, we discuss whether section 809 produces a segment balance of taxes consistent with the allocation of income even though it has not achieved a predetermined numerical split in taxes or a specific level of revenue. For the purpose of our discussion, we assume that one way of judging whether section 809 produces an appropriate split between the stock and mutual segments is to examine how life insurance company income is divided and to see if the allocation of taxes reflects the allocation of income. For the period 1984 through 1987, we found that the segment balance of taxes appeared consistent with the segment balance of income as computed according to the section 809 method.

But, even if section 809 is achieving a proper split between the stock and mutual segments, the method can still raise questions and concerns company by company or year to year. It may properly measure the part of policyholder dividends that represents a distribution of earnings for the average mutual company, yet it may not be allocating the tax burden fairly between companies with strong earnings and those with weak earnings. It may also accurately measure the distribution of earnings in an average year but not in below- or above-average years.

[1]General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the staff of the Joint Committee on Taxation, December 31, 1984, p. 579.

repayment of excess premium) portion of policyholder dividends and does not deduct it. It represents an upper bound on taxable income. In all 4 years the actual mutual tax shares shown in table 1.1 fall below these upper bounds.

The second measure deducts all policyholder dividends, treating them as if they contain only premium rebates and no income. This measure understates the taxable income of mutual companies and stock companies that sell participating policies, since it does not include the part of income that is distributed to policyholders as dividends. It represents a lower bound on the measure of income. The actual mutual tax shares shown in table 1.1 exceed these lower bounds in every year except 1987.

**Table 2.1: Measures of Income and Segment Balance**

Dollars in Millions

| Before policyholder dividends and taxes | Stocks | | Mutuals | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| 1984 | $8,962 | 43 | $11,791 | 57 |
| 1985 | 12,671 | 47 | 14,049 | 53 |
| 1986 | 14,223 | 47 | 16,946 | 53 |
| 1987 | 10,601 | 46 | 12,485 | 54 |
| 1984-87 | 46,457 | 46 | 55,271 | 54 |
| **After dividends but before taxes** | | | | |
| 1984 | 6,515 | 70 | 2,795 | 30 |
| 1985 | 9,812 | 69 | 4,488 | 31 |
| 1986 | 11,037 | 59 | 7,690 | 41 |
| 1987 | 7,243 | 72 | 2,855 | 28 |
| 1984-87 | 34,607 | 66 | 17,828 | 34 |

For the period 1984 through 1987, the stock-mutual split in taxes fell within the wide bands established by these definitions of mutual company income. While these measures are useful for establishing wide parameters, the upper bound includes policyholder dividends that do not represent earnings and the lower bound may exclude policyholder dividends that do represent distributed earnings. Neither measure isolates the part of dividends that is a distribution of earnings to policyholders and includes only that part in income. Chapter 3 suggests a number of ways of measuring the earnings part, but the method we use here is the differential earnings approach embodied in section 809.

seem consistent with the measure of mutual-stock income, including realized capital gains, that is defined by section 809.

## The Tax on Differential Earnings Imposes a Regressive Burden Company by Company and Year to Year

The most troubling aspect of section 809 is the way the tax burden is distributed over firms and over time. The calculations prescribed by section 809 produce an amount that is added to the taxable income of each mutual life insurance company. This amount is meant to measure the earnings that each company pays out in the form of policyholder dividends. The amount is calculated using a formula that starts with the average earnings rate of a sample of stock companies, transforms this into an imputed earnings rate, and then subtracts the average mutual earnings rate. The result, termed the differential earnings rate, is also an average. The taxes that result for individual firms are thus based on earnings measures that are averages.

Because section 809 uses averages in its computations, each mutual company pays taxes on the basis of what the average stock and the average mutual company earn. Thus, companies with below-average earnings will be paying differential taxes (taxes on differential earnings) that are based on the average firm's experience and will be "overtaxed." Similarly, companies with above-average earnings will be "undertaxed."

The averages themselves change from one year to the next. For the period that section 809 has been in force, the imputed rate has changed very little, but the average mutual earnings rate has fluctuated greatly.[4] In years in which the average mutual earnings rate was very low, for example 1984, the differential earnings rate and the extra tax imposed by section 809 were very high. In years in which the average mutual earnings rate was very high, for example 1986, the differential earnings rate was very low or zero, and the extra tax insignificant.

## Companies With Low Earnings Suffer More From Section 809 Than Do Companies With High Earnings

Since some firms have higher-than-average earnings rates and some firms have lower-than-average earnings rates, basing the differential earnings tax on average earnings rates will impose a disproportionately high tax burden on companies with weaker earnings. Differential earnings will be a larger part of total earnings for companies with less-than-average earnings rates, and vice versa. The tax on differential earnings

[4]All of our comparisons that use the differential earnings rate are based on the recomputed rate, since this is the rate that determines the final effect of the law for a particular tax year.

Table 2.3, derived from a ranking of companies by gross earnings rates, demonstrates several important features of the mutual segment and the effect of differential taxes on that segment.

- Mutual firms had different earnings rates. In both years, the top 14 companies had gross earnings rates that were more than twice the earnings rates of the lower 14.
- Firms with higher gross earnings rates also had higher net earnings rates. The top 14 companies ranked by gross earnings rates had net earnings rates that were, on average, large multiples of the earnings rates of the lower 14.
- Whether the differential earnings are measured in relation to gross earnings or to policyholder dividends, the companies with higher earnings had lower differential earnings ratios and therefore lower differential tax burdens. The ratio of differential earnings to gross earnings was more than twice as large for the lower 14 than for the top 14 firms. The ratio of differential earnings to policyholder dividends, which should indicate the proportion of dividends paid out as earnings, was almost twice as high for the lower 14 as it was for the top 14 companies.

To ensure that the results did not depend on splitting the sample in half and to determine whether a different split of the sample would give substantially different results, we ran correlations between gross earnings rates and measures of tax burden. In all cases, there was a statistically significant negative correlation between gross earnings rates and the ratios of differential earnings to total earnings and to policyholder dividends.[7] The strongest correlations were rank correlations.[8] There was a high probability that a company ranked high on the earnings scale would rank low on the two scales of differential tax burden.[9] Results similar to those reported in table 2.3 would therefore have occurred regardless of the split in the sample.

[7]A negative correlation means that high values of one variable are associated with low values of the other. In this case, high values for gross earnings rates were associated with low measures of differential tax burden. The results were significant at the 99 percent confidence level.

[8]Rank correlations compare the position of one variable in a ranking (rather than the value of the variable) with the position of another variable. We ranked firms by earnings rates and compared this ranking with rankings by measures of tax burden.

[9]The rank correlations between gross earnings rates and the ratio of differential earnings to gross earnings were -1. This is because these figures are inversely proportional by definition. Of more interest are the rank correlations between gross earnings and the ratio of differential earnings to policyholder dividends, which were about -0.75 for both years.

are being distributed. On the contrary, while measures of company income changed greatly from year to year, policyholder dividends in relation to equity did not change nearly as much. Since dividends changed very little, there is no reason to think that the distributed earnings component of those dividends was inversely related to the undistributed component.

If the tax on mutual company income were like a standard income tax, an above-average mutual earnings rate (measured after dividends) would be indicative of an above-average year and would lead to above-average mutual company income taxes. If the mutual earnings rate were below average, this would be indicative of a below-average year and mutual income taxes would be lower. Under section 809, if the imputed rate does not change, total mutual taxes do not change. Higher taxes on earnings after dividends are offset by lower taxes on distributed earnings, with the opposite being true if taxes on undistributed earnings are low.

Taxes on the average mutual are not related to the average mutual's performance. Differential earnings and differential taxes are inversely related to the mutual segment's performance: they are high when the segment is having a below-average year and low when the segment is having an above-average year.

For any company, the implications are that if everyone else is doing well, that company's differential taxes are likely to be low, and vice versa. This is another form of "socialization," that is, another instance of a company's taxes being set independently of the company's performance.

## Using a Weighted Average Mutual Earnings Rate May Create Problems for Smaller Mutual Companies

Another concern with the section 809 mechanism results from the method of calculation rather than the idea of imputation. The use of a weighted average to compute the average mutual earnings rate gives the larger mutuals undue influence over the taxes paid by the remaining mutuals. This influence could stem from a conscious attempt by large companies to manipulate their own earnings rate by, for example, paying out extraordinarily high policyholder dividends. This would lower the average rate of earnings retained and raise the differential earnings rate paid by all the mutuals competing against them. As discussed below, even if larger mutuals are not intentionally taking advantage of the section 809 procedure, they did average higher dividend payout

increases its policyholder dividends by $100 million and thus reduces its earnings after dividends from $640 million to $540 million. The initial effect of Maxi's paying out $100 million additional dividends is to reduce its taxable earnings and consequently to reduce its taxes.

A second effect (occurring in the following tax year) is to increase its differential earnings (from $680 million to $695 million) and to increase its taxes on these differential earnings. Maxi's earnings rate falls when it pays out dividends, as does the average mutual earnings rate, in this case from 8 to 7.76 percent. Since the differential earnings rate equals the imputed rate (assumed to stay at 16.5 percent) minus the average mutual earnings rate (now 7.76 percent), it rises to 8.74 percent.[12] The new rate causes Maxi's differential earnings to rise slightly, by $15 million, to $695 million. Coupling this $15 million increase with the $100 million decrease caused by the increased dividends leaves an $85 million net decrease in taxable earnings (from $1,320 million to $1,235 million). As a result, Maxi will pay less tax.

However, Maxi Mutual's actions raise the taxable earnings of the remainder of the mutual segment. The higher differential earnings rate (8.74 percent) is applied to the $32 billion in other mutuals' equity and results in differential earnings rising by $77 million (from $2,720 million to $2,797 million). Total taxable earnings also rise by $77 million—to $5,357 million—and taxes rise accordingly.

The most important point to emerge from this example is that the weighted average mutual earnings rate allows Maxi Mutual to substantially increase the taxable earnings and taxes of other firms in the segment while at the same time lowering its own taxes. The weighted average allows the firm to shift more of the total mutual tax burden to other mutual companies.

A smaller mutual would also be able to increase the taxes of other mutuals while at the same time lowering its own tax burden. In fact, because of its smaller influence on the differential earnings rate, a larger proportion of its taxable earnings and taxes would be passed to other firms. This point was made by the Joint Committee on Taxation in 1984 and provided the rationale for using the weighted average.[13]

[12]The effect on earnings after dividends occurs in the current period, but the effect on the differential earnings rate and on differential earnings will occur in the subsequent tax year under current law.

[13]General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation (1984)

**Table 2.5: Comparison of Average Policyholder Dividend Payout Ratios**

| Year | All mutuals | Largest 10 | Largest 5 |
|---|---|---|---|
| 1980 | .6736 | .6841 | .6990 |
| 1981 | .7536 | .7800 | .8134 |
| 1982 | .7562 | .7718 | .8025 |
| 1983 | .8360 | .8848 | .9134 |
| 1984 | .7364 | .7715 | .7943 |
| 1985 | .7857 | .8215 | .8518 |
| 1986 | .8339 | .8468 | .8427 |
| 1987 | .8731 | .8437 | .8189 |

Note: Policyholder dividend payout ratios are the ratio of policyholder dividends to net gain from operations before payment of dividends and taxes.

A final point about the use of a weighted average is its effect on the regressivity problem discussed in the previous section. If larger companies, on average, have higher earnings rates (after dividends) than smaller companies, the differential earnings rate will be lower than otherwise and the regressivity problem less pronounced. However, if the larger companies have lower earnings rates than smaller companies, the regressivity problem is enhanced.

## Section 809 Introduces Unnecessary Uncertainty About Tax Liabilities

A third set of concerns with section 809 arises because under the current procedure a company calculates its taxable income and pays taxes on the basis of a differential earnings rate that is only tentative. The actual differential earnings rate, to be announced in the following tax year, is based on the earnings experience of the entire mutual segment and is not known at the time of the initial calculation. If the average mutual earnings rate that is used in the initial calculation (the rate from 2 years ago) happens to be close to the actual earnings rate, the amount involved in recalculation and the tax overpayment or underpayment will be small. However, if the initial rate differs greatly from the actual, the recalculation can involve large sums.

For those years in which the companies paid too much initially (years in which the initial differential earnings rate was higher than the final rate), they effectively loaned funds to the government at no interest. In 1985, this interest-free loan amounted to about $373 million and in 1986, about $1,493 million. The opposite effect occurred in 1984 when the initial average mutual earnings rate was too high and the mutual companies underpaid by about $368 million. In this case and again in 1987, the companies were the recipient of the interest-free loan.

## Should a Mutual Company Be Expected to Earn as High a Rate of Return as a Stock Company?

There are two basic reasons why the rate of return earned by mutual companies, including distributed and undistributed earnings, may be consistently below that earned by stock companies: (1) the incentives to pay a competitive rate of return may be weaker for mutual companies than for stock companies and (2) the fact that individuals are not taxed as policyholder dividends are received but are taxed on shareholder dividends implies that the mutual company does not have to pay as high a return to an individual to guarantee the same after-tax rate.

There is evidence in the finance literature, although it is far from conclusive, that mutual companies have weaker market incentives to be efficient than stock companies and thus may pay lower rates of return. This literature starts from the premise that the U.S. stock market is efficient and competitive, so that the shares of a stock life insurance company traded on the stock exchange will have to generate competitive rates of return. Theory holds that if the rate of return on a particular company's shares is low or is expected to fall, the price of the shares should fall. If share prices fall too far, the management is likely to be changed from the inside or through a takeover.

Although market incentives also discipline a mutual company, they are weaker than those that govern a stock company. A mutual company that consistently pays out below-average policyholder dividends has raised the effective price of the insurance it sells, because dividends paid reduce the net premiums charged as the policy ages. The higher effective price will cause the company to lose market share to its competitors. However, calculating the earnings part of policyholder dividends is difficult; thus, judging if the rate of return that the policy earns is competitive with other assets is also difficult. Above all, no market exists for the purchase and sale of ownership claims for mutual companies; thus, there is no fear that a mutual that performs poorly will be taken over.[15]

According to the literature on the relative efficiency of the stock versus mutual forms of organization, mutuals earn a lower rate of return than stocks. Until recently, this literature concluded that the stock form of organization was more efficient than the mutual, whenever conclusions

[15]Policyholders can get rid of the existing management through a proxy fight, but this is more difficult to accomplish with a mutual than with a stock company.

For example, if high earnings for stock companies come at the expense of mutual companies, the mutuals will be forced to pay higher income taxes in years when their income is not, in fact, higher. Of course, the reverse is also true if stock companies are not earning as much as mutuals.

A problem could exist even if there were not a negative correlation between the earnings of stock and mutual companies.[18] If the earnings of stock and mutual companies are not correlated, the mutual segment will still be taxed as if it were doing well even if it is not. This occurs because the high stock earnings rate will affect the imputed rate that in turn forms the basis for calculating the differential earnings for mutual companies.

In addition to the question of the connection between stock and mutual earnings rates for a given year, the correlation over longer periods is also an issue. Is a good year for the stock segment likely to be followed by a bad year or by another good year? This issue arises because the current stock earnings rate is a 3-year average. The use of a 3-year average mitigates the yearly correlation problems discussed above since the effect of a very good or very bad year will be offset by being averaged with standard years. However, the 3-year average also prolongs the effect of the "abnormal" year.

Problems are compounded if one above-average year for the stock companies is likely to be followed by another above-average year, since the mutual segment will pay above-average differential taxes for an extended period regardless of whether its own earnings are above average.

If above-average years are generally followed by below-average years, then over time, the stock earnings rate may be a proper measure for imputing earnings for mutuals. A potential for overpayment in one year still exists, but the overpayment should be offset, on average, in a subsequent year. Depending on the sequence, the government and the mutual segment will be lending one another funds over the period.

In the absence of collusion, a stock company would not find it advantageous to manipulate its income for tax purposes in order to harm its competitors in the mutual segment. The reason for this is that a stock

[18]A negative correlation means that above-average earnings rates for one segment are associated with below-average earnings rates for the other segment.

this rate also raises questions because stock segment gains in earnings can come at the expense of a loss in market share by mutuals.

## Treasury and Industry Comments and Our Evaluation

The two stock company groups who commented believe that our analysis of the segment balance of taxes is flawed because we use the definition of income that comes out of section 809 as our reference standard. They say that as long as we use the definition of income from section 809, taxes and income must be consistent. They would prefer to use a different definition of income.

Our analysis is only intended to determine if taxes were consistent with the definition of income in section 809. Demonstrating that taxes were consistent with the income definition embedded in section 809 is not the same as demonstrating that these taxes were, in any sense, properly allocated. We agree with the stock groups that had their suggested definition of income been used, then the 55 percent mutual/45 percent stock split in taxes would have resulted. However, the tax code is explicit about the base period imputed rate and the resulting definition of income.

The stock groups that commented also want us to use the Treasury figures for taxes in our comparisons. Since our income measures come from financial statements, it is our belief that our tax measures should come from the same source. They also would have preferred that we use the tax figures after "true-up" (recomputation) and exclude 1987. While numbers in a particular year can change with and without true-up, the four year totals are not affected very much except for the last year. For 1987, the true-up will raise the estimate of mutual segment taxes because the final differential earnings rate will be above the initial rate.

Stocks, mutuals, and Treasury criticized our exclusion of realized capital gains from the upper and lower bounds that we calculated for income in our attempts to evaluate segment balance.

Throughout our report we state that realized capital gains are a legitimate part of income, but we excluded these gains in certain contexts. We initially did this because we had indications that, before 1985, these gains were very erratic. In those cases where we wished to get an indication of longer term income measures, we thought excluding them would be useful. In preparing our report, we received additional information that realized capital gains have become a semi-permanent fixture in life insurance industry income. As a result, we have recomputed some of our

# Alternative Methods of Taxing Mutual Life Insurance Companies

In chapter 2, we discussed a number of concerns that arise from employing the mechanism of section 809. Two of the concerns—the use of the stock earnings rate in computing the imputed rate and the use of a weighted, as opposed to an unweighted, average mutual earnings rate—are related specifically to section 809. A third concern—that the differential tax is regressive with a company's income—would result from any method that attempts to impute income to the mutual segment.

This chapter discusses alternative methods for taxing the income that is distributed to policyholders as dividends. The discussion serves several purposes: it (1) highlights the benefits and costs associated with various alternatives, including some indications of the revenue magnitudes involved;[1] (2) distinguishes problems that arise due to a particular alternative from the general problem of taxing the income element of policyholder dividends; and (3) presents a set of methods that, while not solving all of the problems, reduces the degree of arbitrariness and complexity that arises from many of the methods.

The first two alternatives presented—(1) including all dividends in taxable income and (2) deducting all dividends from taxable income, whether paid to stockholders or policyholders—place the discussion in perspective. In addition, we discuss some adjustments to the current section 809 method and the following three alternatives to section 809:

- Allowing mutual companies to deduct all policyholder dividends, including the earnings part, on the principle that they have "prepaid" the tax due on the earnings when they initially included the "excess premium" as part of taxable income.
- Using an earnings rate from outside the life insurance industry (instead of the stock earnings rate) as the basis for imputing a rate of return to the mutuals.
- Including some stated proportion of policyholder dividends in taxable income as a measure of that part of dividends that reflects a distribution of mutual (and some stock) company earnings.

Related to the problem of taxing the company on the earnings part of policyholder dividends is the issue of taxing the individual on the same amount. This is income that can be taxed in addition to what is taxed by section 809, or as an alternative source if section 809 is eliminated.

[1] All of the revenue measures use the magnitudes that occurred between 1984 and 1987. They are not based on simulation models and do not constitute revenue estimates.

out by corporations to their stockholders.[2] Treasury estimated that this proposal would have cost about $20 billion in fiscal year 1988 and $30 billion annually by fiscal year 1990.

If the life insurance industry alone were allowed to exclude all dividends paid from each company's tax base, a smaller revenue loss would result. Dividends paid by stock life insurance companies to their stockholders amounted to over $3 billion per year between 1984 and 1987. If these companies had been allowed to deduct all dividends paid, the annual loss in revenues would have been $1.3 billion per year. This analysis assumes that payout behavior by stock companies would not have changed. However, eliminating the tax on dividends could give companies an incentive to pay out more of their earnings as dividends and lead to even larger revenue losses.

We estimate that about $750 million in annual tax revenue would have been lost if there had been no taxation of policyholder dividends paid out by mutuals. The total expected annual loss in revenue from the entire life insurance industry would have been in the range of $2 billion. A proposal excluding dividends from the tax base of life insurance companies would thus substantially benefit one industry in comparison with others without any compelling reason.

## Excluding All Policyholder Dividends From Taxable Income

A less extreme alternative to excluding all dividends from taxable income is excluding only policyholder dividends. Under the Internal Revenue Code, the policyholder dividends (as opposed to the shareholder dividends) of stock life insurance companies are excluded from taxable income. If the same treatment were extended to mutual companies, the problems of section 809 would be overcome by abolishing the need to distinguish various components of policyholder dividends.

There are basically two arguments for excluding policyholder dividends from taxable income entirely. The first is that these dividends are simply price rebates or returns of excess premiums that are not part of the company's income. According to this view, there is no real equity ownership in a mutual life insurance company, and therefore no return on equity, since there are no shares that can be bought and sold on a market. This lack of liquidity means that a participating insurance policy is a very restricted use of a policyholder's investible funds. However, this

[2]Tax Reform for Fairness, Simplicity, and Economic Growth; Volume I: Overview, U.S. Department of the Treasury (1984).

In discussing his proposal, Graetz presents a set of illustrations that show that in present value terms a mutual company pays the same amount of taxes on the contributions of capital that it receives as a stock company pays on the income generated by the contributions of capital it receives. The difference is that the mutual company pays when the contribution is made, while the stock company pays when the income is generated.

One simple example that Graetz uses compares a mutual company that receives $100 in excess premiums with a stock company that sells $100 in new shares. Both companies face a 35-percent tax rate. The mutual will include the $100 in its taxable income in the year it is received. As a result, it will have $65 available to invest in the company. With a rate of return assumed to be 20 percent, this $65 will generate a stream of earnings of $13 per year for the policyholders.

The stock company receives the $100 and is not taxed on this capital contribution. At the same 20-percent rate of return, the stock company will generate $20 per year for its shareholders; but at a tax rate of 35 percent, only $13 per year will be available after taxes. According to Graetz, the stock company pays no tax initially and $7 per year from then on; the mutual company pays a tax of $35 initially and, to maintain competitive balance, should pay no tax on dividends in subsequent years. Using the 20-percent rate of return for discounting purposes, the two amounts are the same in present value terms.

The basic conclusion that follows from Graetz's argument is that it does not matter whether a tax falls on the initial amount invested, with all subsequent returns untaxed, or on the flow of returns when the initial amount invested is not taxed. In the mutual company case, the amount invested is reduced by the tax (from $100 to $65), and in the stock company case, the returns from the amount invested are reduced by the tax (from $20 to $13). If both are reduced in the same proportion (if the tax rates are the same) and the rates of return before tax are the same, the rates of return after tax will also be the same. Neither tax treatment gives one investment stream or one type of company an advantage over the other. A different way of stating the prepayment proposition is that the taxes prepaid by the mutual are equivalent in present value to the taxes paid by a stock company when both companies earn the same rate of return.

The opposite effect would result if the return were lower than expected. The mutual company's tax would not fall but the stock company's tax would. If companies, on average, find that the actual return on their investment turns out to be equal to the expected return, the prepayment method would give the correct result. However, if companies, on average, do better than expected, the prepayment method would have the mutuals pay too little in taxes, and if they do worse than average, the prepayment method would have mutuals pay too much. The same thing can be said if mutuals, on average, earn more or less than stock companies. In those cases, they will pay too little or too much in taxes, respectively.

There is another sense in which the discount rate can differ from the actual rate of return. From the government's standpoint, the prepayment approach is only equivalent to taxing the returns as they occur if the government's discount rate is the same as the actual rate of return on investment. In the numerical case that we have been using, the present value of $7 paid in taxes each year by the stock company, discounted at an assumed government discount rate of 10 percent, would be $70 compared to the $35 paid by the mutual company. In this case, it would appear to be to the government's advantage to tax all companies as income is earned rather than under the prepayment method. However, this also leads to the anomalous conclusion that, as long as the private sector rate of return is greater than the discount rate, the government is better off postponing the collection of taxes and letting those resources remain in the private sector.

## Transitional Equity Is Not a Significant Problem

Under current law, all premium income is subject to taxation. However, under the 1959 Life Insurance Company Tax Act, mutual companies were primarily taxed only on their investment income as opposed to their underwriting, or premium-related, income. To the extent that this was the case, all or most of the excess premiums paid until the law was changed, effective 1984, were not taxed when they were paid in. Therefore, the return on these untaxed excess premiums should be subject to a tax when paid out, even if Graetz's prepayment method is adopted.

To further complicate matters, between 1959 and 1984, a part of policyholder dividends was disallowed as a deduction and was thus included in taxable income. Therefore, while all of the initial contribution was not taxed, some of the return was.

income element in policyholder dividends. Extending this idea to the individual policyholder appears a natural next step. Second, policyholder dividends differ from inside buildup in that the income is in fact distributed. The policyholder may decide to reinvest the dividends; however, there is a choice. The distribution of dividends is a "constructive realization," a taxable act that is not usually the case with most inside buildup.

A final consideration with the prepayment method is that it would have led to a revenue loss of, on average, $750 million per year. If Congress decides that the mutual segment is paying a double tax as a result of section 809, it should also be aware of the revenue loss that would result from section 809's elimination. While tax policy should not be driven solely by revenues, revenues remain a significant consideration. Thus, even if one were to accept the prepayment method at the company level, strong arguments exist for taxing the part of policyholder dividends that is a distribution of company earnings. The company could report to the individual how much income is in the policyholder dividends, or the company itself could pay the tax as a proxy for a tax at the personal level.[5]

## Imputing Under Alternative Methods

Rather than simply stating that all policyholder dividends should or should not be included in taxable income, other alternatives use an imputation approach to determine what part of these dividends should and what part should not be included. Some of these alternatives use the stock earnings experience as a basis for imputation and are simply modifications to the section 809 approach. Others use a different basis for imputing a rate of return to the mutual segment. Although each of these alternatives would address at least one of the problems described in chapter 2, each would still result in a regressive tax on the income component of policyholder dividends.

### Substituting an Unweighted Average for the Weighted Average

Substituting an unweighted average mutual earnings rate for a weighted average in the section 809 computation would reduce the ability of companies, especially larger ones, to pass taxes on to their competitors by paying out additional policyholder dividends. However, an unweighted average earnings rate may also create undesirable effects.

[5]Since the personal and corporate tax rates differ, a proxy tax requires an adjustment in the rate or the base to reflect the lower personal tax rate.

- Given that averages change over time more gradually than any element in the average, and that they therefore are usually employed to smooth fluctuations, are averages being used to the extent that they could be?
- Given that recomputation is done so that taxes for a particular year are based as much as possible on the circumstances that existed in that year, is it being done with the most current information?

This section discusses how the use of consistent measures for smoothing fluctuations in tax payments and for updating the figures used in recomputations would have altered the performance of section 809. In particular, two alternatives that we examined were able to reduce the amount subject to recomputation. These were (1) using a 3-year average for the average mutual earnings rate, and basing the recomputation on an updated 3-year average; and (2) updating the imputed rate by including the latest stock earnings rate in the moving average.

## Using a 3-Year Average Mutual Earnings Rate

The differential earnings rate is calculated as the difference between the imputed rate and the average mutual earnings rate. The imputed rate is based on a 3-year average of stock rates, while the average mutual earnings rate is a 1-year measure. If both rates fluctuate very little, this arrangement will work satisfactorily. For the period 1984-86, the imputed rate changed very little from one year to the next, whereas the mutual earnings rates ranged between 5.7 and 18 percent if realized capital gains are included and between 1.5 and 7 percent if capital gains are excluded.[6]

Since the average mutual earnings rate has fluctuated more than the imputed rate, the differential earnings rate has also fluctuated. The first alternative we examine uses a 3-year average in computing the initial average mutual earnings rate and an updated 3-year average for recomputation.[7] Our calculations show that this alternative will smooth out the fluctuations and lessen the uncertainty associated with recomputation. The amount subject to recomputation for the period 1984 through 1986 falls from $1,206 million to $515 million.

[6]There is good reason to include realized capital gains in the definition of taxable income. In 1986, realized capital gains were exceptionally high. As a result, the earnings rate calculated for 1986 most likely overstates the kind of sustainable long-run rates that might be expected in the mutual segment. Where it is relevant, we state these earnings rates with and without realized capital gains.

[7]Rather than using a 2-year-old average mutual earnings rate for the initial computation, we are using an average based on the 3 previous years. The update contains the earnings rate for the tax year in question along with that for the 2 previous years.

have been falling (if realized capital gains are excluded). Over the long run stock earnings rates are as likely to rise as fall, so these updating methods will not necessarily result in revenue losses. They should, however, serve the smoothing function effectively.

## Choosing an Imputed Rate From Outside the Life Insurance Industry

Another imputation approach has been part of the debate on taxing the mutual segment of the life insurance industry since at least 1983. This is an approach suggested by Henry Aaron in The Peculiar Problem of Taxing Life Insurance Companies (Washington D.C.: The Brookings Institution, 1983). Rather than use an earnings rate from the stock side of the life insurance industry, Aaron suggested using an imputed rate that is independent of the industry—a tax-free bond rate. This approach offers two variations that would address the problems, discussed in chapter 2, that are raised by using a stock earnings rate as the basis for imputing a rate of return to mutual companies.

Aaron suggested that the appropriate imputation rate for mutual life insurance companies could come from outside the life insurance industry. According to his argument, mutual companies would not have their taxes determined by the performance of stock life insurance companies. Rather, the mutuals would be taxed as if they earned a rate of return equivalent to that of an investment in something like a tax-free bond, for instance, a state or local government bond.

The rationale for this approach is that investments like tax-free bonds have many characteristics in common with life insurance policies purchased from a mutual company. In particular, the returns from state and local government bonds and mutual life insurance policies are not subject to federal personal income taxes. In addition, the imputation rate can be based on tax-free bonds that are held for about the same length of time as, and have risk characteristics similar to, a life insurance policy.[9]

There are two ways that an imputed rate derived from a state and local bond rate can be used.[10] The first method employs a procedure similar to that used in section 809; the second, suggested by Aaron himself, uses

[9]For our computations, we are using a 20-year bond rate index on the assumption that most life insurance policies are bought as long-term investments. Also, since the mutual segment consists of firms with high credit ratings as well as weaker firms, we use the mixed quality index as our reference case.

[10]The tax-free bond rate and the imputed rate are not the same thing, but the imputed rate is derived from the tax-free bond rate.

Whether the first approach (total rate applied to equity) is better than the current system depends on how well its imputed rate tracks mutual earnings rates (including distributed and undistributed earnings) when compared to the imputed rate of section 809. Whether the second approach (Aaron's) is better depends on how well its imputed rate moves with and is of a similar magnitude to the distributed earnings rate, when compared to the differential earnings rate that results from section 809.

The second system does have one advantage over the first in that the part of earnings that is distributed is not based on the subtraction of one rate (mutual earnings rate) from another (an imputed total rate). In this system the rate of earnings that is assumed to be paid out can move independently of the rate of earnings that is retained. As a result, if the mutuals have below-average earnings experience after dividends, they will not be charged with above-average distributions of earnings, as occurs under the current system and to some extent under the first approach.

Throughout the previous discussion, we took as a given the exclusion of policyholder dividends from the personal income tax base. If it were thought advisable to tax the income portion of these dividends at the personal level but difficult to measure this income, the company tax could be used as a proxy. This would involve using a taxable bond rate rather than a tax-free rate for the purposes of imputation. In all cases, the imputed rate would be higher than that associated with the tax-free rate and so would the revenue generated.

## Designating a Part of Policyholder Dividends as Distributed Earnings

Since the purpose of all of the imputation methods is to measure the part of policyholder dividends that is a distribution of earnings, it might be simpler just to designate some proportion of those dividends as taxable income. Such a method would do away with many of the socialization concerns raised in chapter 2 and, in addition, would eliminate the problem that arises when a below-average mutual earnings rate implies an above-average differential earnings rate.

This alternative also allows the policymaker more flexibility. For example, it could be a replacement for section 809 at the company level. If section 809 were kept but individuals were also taxed on the earnings part of policyholder dividends they receive, it could be used to determine that part. If section 809 were to be replaced by the prepayment

the system to evolve over time as the mix of products offered by mutuals changes and as either the return on equity or the part paid out as policyholder dividends changes.

One advantage of this method is that taxes on the amount that represents a distribution of earnings by mutuals will not change drastically from one year to the next, as they do with the imputation methods. This stability is in keeping with policyholder dividend payout behavior of mutual life insurance companies and with stock dividend payout behavior of corporations in general. Mutual and stock companies both tend to pay dividends in accord with expected earnings, allowing some adjustment upward or downward as earnings are greater or less than expected.[12] The experience with corporations, whose distributions to shareholders are easier to measure than a mutual's distributions to policyholders, has been that undistributed earnings and additions to surplus fluctuate more than distributed earnings.

Between 1984 and 1987, section 809 produced a different result. Since the imputed rate changed less than the average mutual earnings rate, the rate that represents earnings paid out has fluctuated as has the differential earnings amount that represents the earnings distributed. The result is that these distributed earnings, as calculated by section 809, have fluctuated more than the distributed earnings paid by other companies. Policyholder dividends, however, have behaved in a manner consistent with the distributed earnings of other companies. A tax on a given proportion of policyholder dividends would produce results more consistent with the smoothing behavior associated with dividend payouts in general.

In addition, the fluctuations in the proportion of dividends attributable to earnings have behaved perversely. If the average earnings rate for the mutual segment is higher than usual, the differential rate will be lower and vice versa. As a result, when mutual companies have higher-than-average undistributed earnings, they are assumed to pay out a lower proportion of their dividends as earnings. All of this assumes that the imputed rate remains the same. If the proportion considered income were stable, as it would be under this alternative, companies would be taxed on the basis of higher dividend payouts if their dividends went up, but the proportion of dividends itself would not increase unless

[12]If earnings are greater than expected, a substantial part of these "excess" earnings is retained for future investment or for periods when earnings are lower than expected. Thus, dividend payments tend to be much smoother than earnings.

The average for the segment ranged from 31 percent in 1985, a comparatively good year, to 53 percent in 1986, a poor year when capital gains are excluded. Under the alternative where the proportion is designated, this ratio would be the same for all companies and for both years so that regressivity according to this measure is eliminated.

If the ratio of differential earnings to gross earnings is examined, table 2.3 shows that the ratios for high and low earnings firms and across years are similar to the comparable ratios of differential earnings to policyholder dividends discussed above. If we had designated 40 percent of policyholder dividends as taxable income, the ratio of differential earnings to gross earnings would have ranged from 39 percent for the companies with lower earnings (rather than the 46 percent resulting under section 809) to 32 percent for the companies with higher earnings (rather than 22 percent) in 1985. Similar effects would have occurred in 1986. The average ratio for all 28 firms would have been about 33 percent in 1985 and about 36 percent in 1986 (instead of 26 percent and 48 percent respectively that occurred under section 809).[14] The alternative that designates a proportion of dividends does not eliminate regressivity according to this measure, but it does reduce it substantially.

## Advantages to Designating a Proportion of Dividends as Taxable Income

One of the major advantages of the tax on a designated proportion of policyholder dividends is that a company's taxes will be subject to its own decisions. Like the Aaron alternative, which uses a bond rate to measure the proportion of income distributed to policyholders, this approach can eliminate the ability of one large company or a small group of large companies to affect the taxes of the other companies in the mutual segment. In addition, the extra tax that results from the designated proportion method is affected by the payout decisions of the company. The tax on policyholder dividends can be reduced but only if the firm pays more direct taxes on earnings. The decision is left to the firm as to what is the proper dividend policy to carry out.

Another advantage of designating an earnings part of policyholder dividends is that the method allows a tax to be assessed on the participating policies issued by stock companies. Much in the manner of the mutual companies, stock companies that sell participating life insurance policies charge a higher initial premium but promise to pay it back with lower

[14] All of these calculations are made using 40 percent as the proportion of policyholder dividends included in taxable income. If a different proportion is chosen, the magnitudes will change accordingly, but the relative effect will be similar.

To have generated revenues from the mutual segment that were in keeping with the actual revenues raised by differential taxes between 1984 and 1987 would have required including about 20 percent of policyholder dividends in taxable income. Excluding realized capital gains, the measured earnings rates would have been substantially lower in 1985 and 1986, and the differential earnings rates and taxes correspondingly higher. In that case, the relevant proportion of policyholder dividends that should have been included would have been over 40 percent. As a result, the actual experience with section 809 could be used to justify a low-end designation rate of about 20 percent of policyholder dividends or a high-end rate of about 40 percent.

**Table 3.1: Taxes on a Designated Proportion of Policyholder Dividends[a]**

Dollars in Millions

| | | Designated inclusion proportion | | |
|---|---|---|---|---|
| **1984** | **Differential taxes[b]** | **20 percent** | **25 percent** | **40 percent** |
| Mutuals | $1,338 | $662 | $828 | $1,324 |
| Stocks[c] | 0 | 85 | 106 | 170 |
| **1985** | | | | |
| Mutuals | 400 | 704 | 880 | 1,407 |
| Stocks[c] | 0 | 88 | 110 | 176 |
| **1986** | | | | |
| Mutuals | 0 | 681 | 852 | 1,362 |
| Stocks[c] | 0 | 93 | 116 | 186 |
| **1987** | | | | |
| Mutuals | 1,284 | 770 | 963 | 1,541 |
| Stocks[c] | 0 | 99 | 124 | 198 |
| **1984-87** | | | | |
| Mutuals | 3,022 | 2,817 | 3,523 | 5,634 |
| Stocks[c] | 0 | 365 | 456 | 730 |
| **Total** | **$3,022** | **$3,182** | **$3,979** | **$6,364** |

[a]The 1987 tax figures are based on a 40-percent tax rate, while the other figures are based on a rate of 36.8 percent. These were the rates in effect in the life insurance industry during those years.

[b]Estimated.

[c]The stock figures exclude policyholder dividends paid by tax-exempt companies.

An alternative approach to defining the designated proportion of policyholder dividends would look directly at dividend payouts to stockholders by stock companies. Both stock life insurance companies and stock companies in general have paid out about 5 to 7 percent of their equity to stockholders in the 1980s. If mutual life insurance companies must compete in the market for asset purchases with these companies, they

## Taxing Dividends at the Policyholder Level

If Congress decides to tax policyholders on the earnings component of their dividends, it can use either of two general methods, both of which could include designating the earnings part. One method would have the companies inform policyholders of the amount of earnings that were included in their dividends. The policyholders would then be responsible for including those earnings on their individual income tax forms and paying any taxes due on that income.

An alternative method, which would be somewhat simpler for the companies and for the individual policyholder, would have the companies pay the tax as a proxy for the policyholder. The mutual companies favor this approach because the tax would be less visible to the policyholder. More specifically, the participating policy would not look like a "taxed" product, while the nonparticipating policy remained "untaxed." In addition, a company-level tax would be applied to the "average" policyholder, whereas the individualized method would apply the average earnings component to each taxpayer, some of whom will have earned more than the average and some less.

One difficulty that arises under the proxy method is choosing the correct tax rate. Individuals can be in various tax brackets and any rate that is chosen will be right for some and wrong for others. Since 1986, the number of tax brackets has been reduced to two, 15 percent and 28 percent.[17] Table 3.2 shows how much revenue would be collected by using these two tax rates and, also, a 20-percent bracket to demonstrate the effects on revenue of some compromise tax rate.

In table 3.2, we have corrected for policyholder dividends paid on group life insurance policies and group annuities. Dividends paid on pensions were not included under the 1982 approach and should probably be exempted under the proxy tax to maintain a level playing field with other financial institutions. In addition, many of the dividends paid to taxable organizations that finance the group policies or annuities should already be included in those organizations' taxable income. There is no need for an additional tax. To make this correction, we have reduced policyholder dividends to 70 percent of the amount on financial statements. This is in accord with Treasury's estimate that about 70 percent of stockholder dividends are received by taxable entities.

[17]There is also a 33-percent bracket, but for simplicity we are using the two brackets that cover most taxpayers.

policies. This is because these refunds are paid to companies and organizations that fund the group and are already included in income.

Excess interest presents a more complicated problem. Certain nonparticipating policies, such as universal life policies, credit a significant amount of excess interest to the policyholder's account. The policyholder is not always given the option to receive this interest in cash as a normal part of the dividend distribution process. This does not mean that the policyholder cannot gain access to the excess interest. Should the policyholder borrow against or partially surrender the policy, the excess interest or any interest can be taken out of the policy. This is true of all life insurance policies, however, and represents a different concern than the one we are addressing in this report. For these non-participating policies that credit excess interest to policyholder accounts, the basis for inclusion or exclusion under the proxy should depend on whether a cash option exists as part of the normal process of crediting dividends. If it appears that companies are attempting to disguise participating policies as non-participating policies in order to avoid the proxy tax, it may be necessary to revisit the exclusion of excess interest from the tax base.

The proportion of policyholder dividends that is to be included in income under the proxy tax should be selected by using whatever measure of differential earnings or shareholder dividend payouts is chosen and dividing it by the broader measure of policyholder dividends. The result will be a smaller proportion than those discussed above, but it will be applied to a larger base and should raise the same revenue from the mutuals, but more revenue from the stock companies.

## Conclusions

All of the alternatives—the Graetz approach, adjusting section 809, the two approaches that use the tax-free bond rate, and the tax on policyholder dividends—attempt to deal with one or more of the problems with varying degrees of success.

While it may give rise to some concerns, the Graetz approach appears to be substantially correct at the company level. From the standpoint of sound and practical tax policy, a company should be allowed to fully deduct policyholder dividends. While eliminating these dividends from the corporate tax base will result in less tax revenue, much or all of the revenue loss could be made up by imposing a tax at the company (as a proxy) or the individual level on the earnings received by policyholders. This would require imputation or some similar method to determine how

raised less revenue than the current system. This will always be the case with the prepayment method without a tax on earnings at the policyholder level but need not be true of the approaches that use the bond rate. The adjustments to section 809 are mainly to smooth out fluctuations and should have no long-term revenue implications. The option to designate a proportion of policyholder dividends as part of taxable income can be designed to be revenue-neutral, but by including the policyholder dividends paid out by stock companies in the tax base, it can also raise substantial additional revenues.

A proxy tax has many advantages as a method of taxing the earnings of policyholders. It should help keep compliance and administration costs low. Since the tax will apply to the average policyholder of a company, it will also reduce the possibility of individual policyholders being overcharged or undercharged on particular types of policies as a result of the imputation.

As a mechanism for taxing the earnings part of policyholder dividends—whether as a substitute for the current section 809 approach or as a supplement to the prepayment approach for taxing dividends at the policyholder level—the alternative that designates a proportion of policyholder dividends as part of taxable income appears to stand out from the rest. Most of the objections to it are minor when compared to its advantages. The fact that it can incorporate variants of the other alternatives, such as the bond rate methods or the proxy tax for policyholders under Graetz's approach, demonstrates its flexibility.

It is up to Congress to decide on what basis to designate the percentage of policyholder dividends that is taxable, but once that is decided, this approach can incorporate the decision. We believe that using the dividend payout rate of shareholder-owned companies has fewer disadvantages than any of the alternatives examined.

The approach that designates a proportion of policyholder dividends also has the advantage of generating a predictable stream of revenue. The amount of this revenue will depend on whether Congress decides to include the policyholder dividends of stock companies.

There is no obvious solution to the problem of measuring the income paid by mutual companies to their policyholders. However, because section 809 generates a number of problems, it should be replaced. While the Graetz argument appears fundamentally correct at the level of the company tax, there is still the need for a policyholder tax to provide for

## Validity of the Prepayment Approach

The Treasury report finds the basic prepayment approach to be convincing although it contains certain reservations about a few key assumptions. The mutuals and State Farm endorse the basic premises of the prepayment approach. The two stock groups are very much opposed to adopting the prepayment method.

We do not mean to suggest that the prepayment approach will give exactly the right answer in every set of circumstances. It is a form of imputation and, as such, can only be expected to be correct on average. However, we agree with Treasury that it is a sound practical way to deal with the problem of taxing mutuals at the company level.

In their comments the stock groups say that there is no way to quantify the excess premium in a mutual life insurance policy. They assert, for example, that the premiums charged for mutual policies can be higher or lower than an equivalent policy issued by a stock company.

To be sure, the amount of the excess premium cannot be easily identified. Mutual companies do not usually know how much of the premium they charge is excess. Some companies charge higher premiums and pay more dividends while others charge lower premiums and pay lower dividends. The dividends these companies pay will depend on what actually occurs from the standpoint of investment returns, mortality experience, and other expenses. What was excess may be calculable after the fact, but only estimable in a rough way before the fact.

But the fact that the redundant premium cannot be precisely measured does not mean that it does not exist. The existence of such an excess premium is strongly implied by the payment of an equity return. If there was no excess premium, there would be no basis for an equity return. The stock groups state that the policyholder dividends paid by stock companies are price rebates or repayment of excess premiums. However, at least part of the dividends paid to mutual policyholders are also repayment of premiums greater than that necessary to finance insurance coverage.

The stock groups also maintain that even if a redundant premium could be identified, it is not a source of capital. They assert that mutuals have generated their capital through retained earnings. If their premiums are higher, it is higher profit and not more capital.

Even if much of the surplus generated by mutual companies has come from retained earnings, this income was subject to taxation on the same

The section 809 formula does have the odd feature that if the average mutual earnings rate rises, the differential earnings rate falls point for point. For any company, however, the effect of receiving one dollar in excess premium is to raise its income by one dollar. Taxes would go up by the tax rate multiplied by the increment in taxable income. The higher earnings of this company would affect the average earnings rate for the segment. However, the effect on the segment's earnings rate would be less than point for point and would depend on the size of the company.

For the segment as a whole, it is true that a dollar of excess premium does not affect the total taxes of the segment. The way section 809 is currently written, nothing the segment does, with the exception of altering its equity, has any effect on its total taxes, only on the composition. What one company does, however, can affect how the segment's tax bill is divided up company by company.

The stock groups also argue that the prepayment approach is not valid in terms of its actual results. In particular, if the discount rate used to compare present values differs from the actual rate of return, there is no reason to expect the taxes generated by stocks and mutuals to be equivalent.

As discussed in the chapter, there are two aspects to our discussion of discount rates. The first deals with the discount rates used by companies. The prepayment approach uses the actual rate of return as the discount rate. If firms use an expected rate of return as their discount rate and the actual rate of return equals the expected, there is no problem and the prepayment approach will always give the correct answer. If the actual rate of return is greater than expected, the mutuals will not pay as much in taxes as the present value of the taxes paid by a stock company with the same rate of return. On the other hand, if the rate of return is less than expected, the mutuals will prepay more than the present value of taxes paid by the stock company.

On average, we believe that actual returns are about equal to expected. Consequently, the prepayment approach may not be valid in each and every case but it should be correct on average. It is in this sense that we find it a practical approach to tax policy. From a conceptual standpoint it can be argued that, even if the actual taxes paid by the mutual company differ in a present value sense from those paid by the equivalent stock company, the income lost by the two companies is the same.

that the return has to be shared with stockholders but some return on excess premiums is paid.

Many policies that are not called participating, such as universal life policies, are difficult to distinguish from participating in the way they generate returns to the policyholder. There may, in fact, be no excess premium, but the return paid out is based on the company's performance and appears, for many practical purposes, as an equity return. Excess interest is considered a policyholder dividend for tax purposes and, if the policyholder has the option to take that amount in cash, it would appear that it is not inside buildup in the traditional sense. Restricting the tax to dividends paid on participating policies is an option, but companies may react by renaming their policies. They can call a policy nonparticipating even though it has all the characteristics of a participating policy, including a distribution of equity returns. For this reason, we favor the broad definition of policyholder dividends.

## The Policyholder Tax as a Proxy Tax

The Treasury Department considered the proxy tax as an option, but did not recommend it, because of the problem of measuring the earnings part of policyholder dividends, especially for stock companies. The mutual companies favor some form of proxy tax. The stock companies are against a proxy tax arguing that it would be unfair to tax policyholders on the basis of some average tax rate. Instead, they suggest the option, discussed in our report, of notifying all policyholders of their taxable amounts and having individual taxpayers include these amounts in their adjusted gross income.

We recommended the proxy tax after considering a set of alternatives. We continue to believe that the advantages in administrative and compliance simplicity outweigh the problems of not getting the tax rate exactly right. One reason is that the amounts, for most people, will not be very large. In addition, because they are based on averages, the amounts may not be exact for each policyholder. They are more likely to be correct for the average policyholder of a company.

## The Amount of Revenue Raised by Our Suggested Tax

The Treasury report includes a revenue estimate of its version of the proxy tax. Both the mutual and the stock groups estimated how much revenue our approach would raise. The mutuals also included a measure of how much they think a correct proxy tax should raise as well as an estimate of how much section 809 would raise if it were continued. The

4. Calculate the average mutual earnings rate. This rate is the sum of the gain or loss from operations, after subtracting policyholder dividends, plus realized capital gains for all mutuals divided by the sum of the average equity for all mutuals. Treasury calculates and announces this rate. For the initial computation (step 5), these two amounts are for the second calendar year before the tax year in question, or in this case 1983. For a subsequent calculation (step 7), the average mutual earnings rate for the current year, in this case 1985, will be used.

The average mutual earnings rate for 1983 was 10.166 percent, and for 1985, it was 13.135 percent.

5. Calculate the initial differential earnings rate. The difference between the imputed earnings rate (step 3) and the average mutual earnings rate (step 4) is the differential earnings rate. The imputed rate's purpose is to measure the total return on equity earned by mutuals. The average mutual earnings rate measures the rate of return on equity that was retained, or not distributed, by mutuals. Therefore, the difference measures the return on equity paid out to policyholders. This rate is announced by Treasury.

The initial differential earnings rate for 1985 was
16.323 − 10.166 = 6.157 percent

6. Calculate the differential earnings amount for a particular company. This amount is the product of the differential earnings rate for all mutuals (step 5) and the average equity of a particular mutual. It measures the part of policyholder dividends that is a distribution of earnings and is not deductible in the calculation of a firm's taxable income.

Average equity for the mutual segment was estimated to be $34.1 billion, so the differential earnings amount is 6.157 percent of $34.1 billion, or $2.1 billion.

7. Calculate the taxes on differential earnings for a particular company. This amount is the product of a company's differential earnings amount (step 6) and the effective tax rate for a life insurance company.

The effective tax rate for 1985 was 36.8 percent, so the taxes on differential earnings were $773 million.

8. Recompute the differential earnings rate on the basis of updated information. The initial computation was based on an average mutual

**Table I.1: Calculations of Earnings Rates, Amounts, and Taxes for 1985**

Dollars in Billions

| Step | Amount Given | Amount Calculated |
|---|---|---|
| 1. Stock earnings rate | | |
| a 1982 | 18.812% | |
| b 1983 | 18.535% | |
| c 1984 | 16.731% | |
| d Current stock earnings rate (1a + 1b + 1c)/ 3 | | 18.026% |
| 2. Stock earnings rate | | |
| a 1981 | 17.316% | |
| b Base period (2a + 1a + 1b)/ 3 | | 18.221% |
| 3. Imputed earnings rate (1d / 2b) × 16.5% | | 16.323% |
| 4. Average mutual earnings rate | | |
| a 1983 | 10.166% | |
| b 1985 | 13.135% | |
| 5. Initial differential earnings rate 3a − 4a | | 6.157% |
| 6a. Estimated equity for mutuals | $34.100 | |
| 6b. Initial differential earnings amount 5a × 6a | | $2.100 |
| 7a. Effective tax rate | 36.800% | |
| 7b. Taxes on differential earnings 7a × 6b | | $0.770 |
| 8. Recomputed differential earnings rate 3a − 4b | | 3.188% |
| 9a. Recomputed differential earnings amount 8a × 6a | | $1.100 |
| 9b. Adjustment in taxable income 9a − 6b | | −$1.000 |
| 10. Recomputed differential earnings taxes .368 × 9a | | $0.400 |

# Estimation Methodology

## Sample Selection

Our sample consisted of the 50 largest stock and 28 largest mutual life insurance companies, along with their life insurance subsidiaries and affiliates, licensed to do business in the District of Columbia. The rankings were based on asset holdings as of December 31, 1985, as reported by Best's Review. The financial statements for each company were obtained from the District of Columbia Insurance Administration. The companies were combined into life insurance groups, where relevant. The individual data items were aggregated into a data set consisting of 50 consolidated stock and 28 consolidated mutual companies.

## Mutual Segment Sample

Our original sample for the mutual segment included 30 of the 31 companies with the largest total assets. The one company not included (Union Mutual Life Insurance Company) operated as a mutual in 1985 but as a stock company in 1986. On the basis of subsequent information, we dropped two companies (Mutual of Omaha and Mutual of America) because they are not taxed as life insurance companies.

The mutual sample also included 53 stock subsidiaries of the selected mutual companies. For the purpose of calculating the earnings rates and average equity bases required by section 809, any affiliated group that includes a mutual parent and stock subsidiaries is treated as one mutual life insurance company. Therefore, these stock subsidiaries were consolidated with their mutual parents for all of our calculations.

As of December 31, 1985, these 28 consolidated companies controlled total assets of $419 billion, or 92 percent of the mutual segment total. As of December 31, 1986, the selected companies controlled assets of $464 billion, or 93 percent of the mutual segment total.

## Stock Segment Sample

Our sample of 50 stock life insurance companies was selected from the companies listed by Best's Review as having the most assets at the end of 1985. Our lowest ranked company in the selected 50 was ranked 87th in Best's Review. Of the other 37 companies, 27 were included in our analysis as subsidiaries of other stock companies (22) or as subsidiaries of mutual companies (5). The remaining 10 companies included 7 that were not licensed to do business in the District of Columbia, one that was a nonprofit, one that was foreign, and one that was a subsidiary of a company that was a mutual in 1985 and a stock company in 1986.

Section 809 states that the stock earnings rate will be calculated from the 50 largest stock companies in a particular year. For the purposes of

There is no explicit mention of voluntary reserves or of the difference between reserves for statutory and tax purposes. As a result, the assignment of reserves as voluntary was based on our interpretation. This will be discussed in the next section. For the difference between reserves for statutory and tax purposes, we used a simple rule of thumb. We approximated this difference using 5 percent of reserves valued on a net-level basis. Net-level reserves is an item that comes from a schedule attached to the financial statement

## Voluntary Reserves

Companies do not list voluntary reserves as a category on the annual statement. These are reserves that are not required by any state regulatory authority. Thus, we had to use certain guidelines to decide which reserves were required and which were voluntary. We assumed that reserves whose category headings included words such as contingent, for contingencies, fluctuation, special, or for stabilization were likely to be voluntary as opposed to required. Since the mandatory securities valuation reserve is required, we assumed that those labeled "investment valuation reserves" were also voluntary.

## Adjusted Capital and Surplus

Since most of the calculations were based on consolidated balance sheets, which included parent and life insurance subsidiaries or affiliates, some adjustments were necessary to avoid double counting. This is a particular problem in measuring the capital and surplus of a consolidated company. Some or all of the capital and surplus of the subsidiary is contained in the capital and surplus of the parent. Simply adding up the capital and surplus for all of the firms in a consolidated group would count some capital and surplus twice—once to the subsidiary and once to the parent. It is not clear how much of a subsidiary's surplus is included in the capital and surplus of the parent.

There are three different ways of dealing with this issue:

- Ignore it and realize that capital and surplus of the consolidated firm are overstated owing to double- counting.
- Assume all of the subsidiary's capital and surplus is included in that of the parent and realize that if it is not, capital and surplus of the consolidated firm will be understated.
- Subtract out the capital of the subsidiary but not the surplus, since the first is included in the capital and surplus of the parent but the surplus may not be.

data was also the year in which realized capital gains for the mutuals were exceptionally high. This, in turn, led to the mutual earnings rates being very high for 1986. In fact, they were so high that the differential earnings rate for 1986 was zero. Since a differential earnings rate of zero would affect everyone in the same way by not affecting anyone, we would not be able to measure any effect of the section 809 method for 1986.

As an alternative, we decided to measure what the differential earnings rate would have been if there had been no realized capital gains in 1986. What was a very good year when these gains are included turns out to be a very poor year when only gains from operations are included. This results in a large increase in the differential earnings rate for 1986. For purposes of comparability, the same adjustments were made to the 1985 figures. In our calculations, 1986 is used as an example of a "bad" year and 1985 as an example of a "good" year. In fact, 1984 was probably the worst year for mutuals when all earnings are considered. The conclusions reached in table 2.3 (see chapter 2) for 1986 apply more to 1984 than to 1986, but the principle is the same—when mutuals do badly they pay more differential taxes and the differential tax burden is heaviest on the weakest earners.

The measures of differential tax burden are the ratio of differential earnings to policyholder dividends and the ratio of differential earnings to gains from operations before payment of policyholder dividends. The measure of differential earnings is our computed differential earnings rate—excluding realized capital gains from both the imputed and mutual earnings rates—multiplied by our measure of each company's equity.

The Treasury Department report recommends that section 809 be replaced with an investment earnings tax that applies to all life insurance companies in order to provide more consistent tax treatment between income flowing through life insurance companies and income flowing through other financial institutions. Under this proposal, life insurance companies would pay a tax equal to a percentage of net investment income on life insurance contracts. To maintain revenue neutrality with the expected level of collections under section 809, the tax rate would be one percent initially, but would be phased up to approximately two percent. The Treasury Department report also recommends that stock life insurance companies be allowed a shareholder dividends-paid credit equal to the estimated individual tax liability on dividends paid, to compensate for the fact that equity returns to stock company shareholders are taxed twice, whereas equity returns to mutual company policyholders are not. A credit equal to 15 percent would offset the effective tax rates on dividends paid to shareholders.

The Treasury Department's proposed approach has several advantages over the current system of life insurance company taxation. First, the taxation of total returns on participating policies would apply equally to mutual and stock companies. Second, the double taxation of equity returns of stock company shareholders would be reduced with the dividends-paid credit, placing them on a par with the current individual tax treatment of participating policyholders. Third, the taxation of financial products across different financial institutions would be made more consistent by ensuring that investment income flowing through life insurance companies is taxed at least once at either the corporate or individual levels.

In addition to providing the comments noted above, I have enclosed detailed technical comments on the GAO's draft report.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

4. Companies with Low Earnings Suffer More From Section 809 Than Do Companies With High Earnings (pp. 30-4)

Table 2.3 is incomplete because the measure of earnings rates excludes realized capital gains. The statutory definition of earnings rates includes realized capital gains.

5. Use of the Weighted Average Mutual Rate and Small Company Effect (pp. 37-8)

The draft GAO report is correct that a large mutual company can affect the taxes of small mutuals under section 809 without having a net negative effect on its own taxes. However, the Treasury Department's 1989 report shows that smaller mutual companies benefited from the weighted average mutual earnings rate formula because the additional taxes attributable to section 809 were lower in 1986 than they would have been if the average earnings rate were unweighted. For a detailed discussion of this point see Appendix C of the Treasury Department's 1989 report.

6. Imputing Income Under Alternative Methods (pp. 71-82)

An unweighted average mutual earnings rate would have increased the differential earnings rate in 1986. The high earnings rates of large mutual companies benefited small companies. See Appendix C of the Treasury Department's 1989 report.

7. Designating a Part of Policyholder Dividends as Distributed Earnings (pp. 82-98)

The draft GAO report is correct that a portion of policyholder dividends of mutual and stock life insurance companies should be included in the income of policyholders. However, this approach creates practical difficulties in identifying and measuring returns to participating policyholders, particularly with regard to stock company participating policyholders. See Chapter 5 of the Treasury Departments's 1989 report.

(ii) mutual life insurers have never before been allowed such a deduction, and (iii) Congress has expressly stated that "no company should engage in [the life insurance business] without being subject to Federal corporate income taxes." H.R. Rep. No. 98-432, pt. 2, 98th Cong., 2d Sess. 1398 (1984) (emphasis added). Since the GAO discussed and rejected allowance of a full deduction for stock companies' distributed earnings, we can only view the proposed recommendation as biased in favor of mutual companies.

Second, the GAO's proposed recommendation would tax policyholders of stock life insurance companies (by way of the proposed proxy tax at the company level) on amounts paid or credited under their policies. This amounts to a tax on the inside buildup of life insurance policies, something the life insurance industry has unswervingly opposed. As you are aware, in the past (as recently as 1986) Congress has considered such proposals at length and has rejected them. The GAO's attempt to resurrect such a proposal is not a constructive contribution to the problem Congress requested the GAO to address: alternative methods of taxing mutual life insurance companies. Further, the proposed imposition of the policyholder-level tax as a proxy is improper and biased in favor of mutual companies -- improper because it would overtax some policyholders and undertax others, and biased in that it apparently is being recommended because mutual companies desire to have it imposed in this way and despite the fact that stock companies' owners are taxed directly.

In sum, we think that the GAO's proposed recommendation is totally unwarranted and unfair to stock life insurers. Given that stock and mutual life insurance companies are in direct competition with one another, common sense alone dictates that, above all, any recommendation given should not favor one segment over another. Yet, the proposed recommendation would slash the already low level of corporate taxes paid by mutual life insurers and pay for it by boosting the taxes of stock life insurers. As the graphs and chart attached to this letter clearly show, mutual life insurers' taxes have fallen sharply in recent years (down to less than $1 billion annually) even as their economic income, out of which they pay dividends, has risen dramatically. Overlooking this, the GAO proposes to have the mutual segment of the life insurance industry pay tax annually of $800 million at most, while imposing tax liabilities on the stock segment approaching $3 billion annually. Thus, despite the fact that stock companies have less than 50 percent of the industry's assets and about 40 percent of its pre-dividend net income, the GAO would have them pay nearly 80 percent of the industry's tax. Far from providing a level playing field, such a recommendation would tilt it decidedly in favor of one segment of the industry.

# Comments From the National Association of Life Companies

**National Association of Life Companies**

An Association of Life & Health Insurance Companies

September 15, 1989

Dr. Natwar M. Gandhi
Assistant Director
Tax Policy and Administrative Issues
United States General Accounting Office
1440 New York Avenue, N.W.
Washington, D.C. 20005

Re: Comments on the GAO Draft Report on the Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry

Dear Dr. Gandhi:

On behalf of our 624 member companies, we want to thank you for forwarding to us a copy of your draft report entitled, "TAX POLICY: Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry." We also appreciate your meeting with us during your preparation of the report and listening to our concerns on behalf of the smaller companies.

We were pleased with that portion of your report which drew from our meeting by finding that the present tax system allows large mutual life insurers to increase substantially the taxable income and taxes of the smaller mutual companies, while at the same time lowering their own taxes. As we stated to you, we believe that Congress should provide relief for the small mutual companies and take steps to eliminate the undertaxation that the large mutuals have enjoyed at the expense of smaller companies.

In addition to reviewing your draft, we have also reviewed the September 7 comments to that draft made by the Stock Company Information Group and are concerned that your proposal would produce an increasing segment imbalance as to what mutuals and stocks would have to pay. Instead of the 55/45 (mutuals/stocks) segment balance aimed for, but missed by the 1984 Act, the mutual segment of the total tax from the life industry could be further decreased to as low as approximately 22% when you consider that mutual companies would not pay any tax on distributed earnings nor would their policyholders pay any tax similar to that paid by the owners of the stock companies.

1850 Pennsylvania Avenue, N.W. • Suite 1250 • Washington, D.C. 20004-0401 • (202) 783-6252

# Comments From the Mutual Life Insurance Tax Committee

September 15, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General
Accounting Office
Washington, D.C. 20548

Re: Summary of Mutual Company
Comments on GAO Draft Report

Dear Mr. Fogel:

In response to your letter of August 1, 1989, we are submitting comments of the Mutual Life Insurance Company Tax Committee on the draft GAO Report, Tax Policy: Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry. The Mutual Life Insurance Company Tax Committee is a group of more than 60 mutual life insurers.

Mutual companies recognize that GAO has devoted substantial efforts over the past two years to its study of the taxes paid by the life insurance industry and the operation of section 809 of the Internal Revenue Code. Despite many competing demands, the GAO staff has completed an examination of these complex life insurance tax issues in a thorough and impartial manner.

Mutual companies support most of the major findings presented in the Draft Report: because the Graetz prepayment analysis is fundamentally correct, section 809 imposes an unwarranted additional tax on mutual companies at the corporate level and should be repealed; any tax law change designed to tax policyholders at the individual level should apply equally to stock and mutual companies; mutual companies have paid taxes consistent with their income for the period 1984-1987; and the traditional notion of segment balance should be rejected. The comments below focus on these findings and suggest refinements in the form and quantification of the proxy tax recommended in the Draft Report.

I. Mutual Companies Support Most of GAO's Major Conclusions

A. Validity of the Prepayment Analysis and Repeal of Section 809

The Draft Report finding that the Graetz prepayment analysis is "fundamentally correct" at the corporate level, (pp. 99, 103) is consistent with the conclusion of the Treasury Report and every independent expert who has examined the issue. Based on its conclusion, the Draft Report recommends repeal of section 809 of the Internal Revenue Code. (p. 103)

Mutual companies believe that the conclusion that an additional corporate-level tax on mutual companies is unjustified should be accorded special weight in upcoming legislative deliberations on life insurance taxation. The GAO participated in the legislative process leading to enactment of section 809. It has studied the 1984 Act

Mutual companies believe that GAO's conclusions regarding segment balance should be presented as major findings of the study and emphasized in both the executive summary and the text of the Report.

II. Comments on Proxy Tax Proposal

The Draft Report recommends that section 809 be replaced by a tax paid at the company level by both stock and mutual companies as a proxy for a tax at the policyholder level on any earnings portion of policyholder dividends. (pp. 101-104)

We note as a preliminary matter that the Draft Report states incorrectly that "the personal income tax does not apply to the earnings component of policyholder dividends." (p. 14) This statement is inaccurate because individuals are taxed currently on gains when they surrender their contracts and when amounts received under the contract (e.g., withdrawals, cash dividends) exceed investment in the contract. Thus, any earnings component contained in dividends may be subject to tax in the hands of the policyholders, depending on the circumstances.

The GAO recommendation approximates the dividend payout ratio of stock corporations (at 5-7 percent of equity), applies this percentage to mutual company equity, translates the resulting amount into a portion of policyholder dividends (25 percent),[1] and then recommends taxing that amount of dividends at an individual tax rate.

It is important to note that a proxy tax on such equity returns can be fashioned without the unnecessary, additional step of translating returns on equity into a portion of dividends. Equity multiplied by the corporate dividend payout rate could simply be multiplied by an average shareholder tax rate (reduced to take into account the portion of shareholder dividends distributed to corporations, pension plans, tax-exempt entities, etc.). The result would then be divided by the corporate tax rate to determine the portion of additional income that would be added to an insurer's taxable income as a proxy for the policyholder tax. Such an approach was recommended by Dr. Gerard Brannon in his 1986 report to the Treasury on life insurance taxation.[2] Such an equity-based proxy tax also avoids the very serious problems in defining dividends. For these and other reasons, we think it might be appropriate to base a proxy tax on equity rather than dividends.

The Draft Report could also leave a mistaken impression that GAO recommends a proxy tax to be applied to a base of 25 percent of dividends even though the Draft Report notes that this percentage would be lower if the correct measure of dividends

---

[1] This percentage was apparently calculated by multiplying mutual equity by a payout rate of 6 percent and dividing the product by total statutory dividends.

[2] G. Brannon, Report on Life Insurance Segment Balance § 2.3 (September 1986).

# Comments From the State Farm Mutual Automobile Insurance Company

State Farm Mutual Automobile Insurance Company

ONE STATE FARM PLAZA
BLOOMINGTON, ILLINOIS 61710

ROGER JOSLIN
SENIOR VICE PRESIDENT AND TREASURER
PHONE (309) 766 2934 OR 766 2786

September 14, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Re: GAO Draft Report on TAX POLICY: Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry

Dear Mr. Fogel:

On behalf of State Farm Life Insurance Company, I am writing in response to your request of August 1, 1989 for our comments on the GAO draft report on life insurance company taxation.

State Farm Life is a stock life insurance company and ranks in assets about 20th among life insurance companies. It is a substantial taxpayer; for example, in 1987, it paid Federal income taxes of $74 million. State Farm Life's effective tax rate significantly exceeds the effective tax rate of the life insurance industry as a whole.

State Farm believes that the goal of tax policy should be to measure accurately each company's economic income and to tax such income equitably. Taxation should not unduly burden the consumer, nor interfere with the historic social role of life insurance protection for individuals and families.

We commend the GAO draft report for its careful analysis of the problems in applying existing Section 809 of the Internal Revenue Code. We agree with GAO that Section 809 does not follow a pattern normally associated with income taxes. We also agree that the basic Graetz analysis is fundamentally correct.

The concept of a "proxy tax" on life insurance companies, in lieu of a tax on some policyholders, is novel and very troublesome. Such an approach should not be considered on the basis that it may be in some respects better than Section 809 or because it would be a hidden tax. Any new approach needs to be justified on its own merits under sound norms of tax policy.

# Major Contributors to This Report

## General Government Division, Washington D.C.

Natwar Gandhi, Assistant Director
Lawrence Korb, Assignment Manager
Thomas McCool, Economist-in-Charge
William Simpson, Actuary
Frederick Herzfeld, Evaluator

| | |
|---|---|
| Equity Base | An amount equal to the surplus and capital<br><br>(1) increased for nonadmitted financial assets,<br><br>(2) increased for the excess of statutory reserves over tax reserves,<br><br>(3) increased by the amount of any mandatory securities valuation reserve,<br><br>(4) increased by the amount of any deficiency reserve,<br><br>(5) increased by the amount of any voluntary reserve, and<br><br>(6) increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year. |
| Excess Premium | The amount by which the premium for a participating life insurance policy exceeds the premium for a similar nonparticipating life insurance policy. |
| Imputed Earnings Rate | An amount which bears the same ratio to 16.5 percent as the current stock earnings rate for the taxable year bears to the base period stock earnings rate. |
| Life Insurance Policy | A contract of insurance providing for payment of a specified amount on the insured's death either to his estate or to a designated beneficiary. |
| Mandatory Securities Valuation Reserve | A reserve computed according to a formula specified by law or regulations designed to provide for possible losses incurred on securities. |
| Mutual Life Insurance Company | A life insurance company owned and controlled by policyholders. The company generally issues participating life insurance policies, which entitle the policyholder to share in the company's surplus earnings through dividends reflecting the difference between the premium charged and the actual experience. |

| | |
|---|---|
| Statutory Reserves | Reserves required by state regulators to assure that an insurance company will be able to meet its obligations when due. |
| Stock Earnings Rate | The numerical average of the earnings rates of the 50 largest stock companies for any calendar year. |
| Stock Life Insurance Company | A life insurance company owned and controlled by stockholders who share in the surplus earnings. The company generally issues nonparticipating life insurance policies, but may also issue participating life insurance policies. |
| Tax Reserves | Reserves allowed to be taken into account for tax purposes. |
| Voluntary Reserves | Reserves established by an insurance company, but not required by state law. Such reserves are not established to meet specific obligations. Rather, they represent the designation of surplus for particular purposes. |

**Requests for copies of GAO reports should be sent to:**

**U.S. General Accounting Office**
**Post Office Box 6015**
**Gaithersburg, Maryland 20877**

**Telephone 202-275-6241**

**The first five copies of each report are free. Additional copies are $2.00 each.**

**There is a 25% discount on orders for 100 or more copies mailed to a single address.**

**Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.**

| | |
|---|---|
| Net Level Reserve | A policy reserve computed by a method that makes no allowance for higher first-year expense. A uniform part of each year's premium paid by the insured is used for reserve purposes. |
| Nonadmitted Financial Assets | Financial assets of an insurer not permitted by a state to be taken into account in determining the insurer's financial condition. |
| Nonparticipating Insurance | Insurance on which no dividends are payable. Usually issued by a stock life insurance company at premium rates that are lower than those charged when dividends are payable. |
| Participating Insurance | Insurance on which the policyholder is entitled to share in the insurance company's surplus earnings through dividends that reflect the difference between the premium charged and the actual experience. |
| Policyholder Dividend | A refund of part of the premium on a participating life insurance policy. It is a share of the insurance company's surplus earned, apportioned for distribution, and reflects the difference between the premium charged and the actual experience. |
| Segment Balance | Refers to the allocation of the industrywide tax burden between the mutual and stock segments. |
| Statement Gain or Loss | The net gain or loss from operations required to be set forth in the annual statement, determined without regard to federal income taxes and<br><br>(1) determined by substituting for the amount shown for policyholder dividends the amount of deduction for policyholder dividends as defined by section 808 of the Internal Revenue Code,<br><br>(2) determined on the basis of tax reserves rather than statutory reserves, and<br><br>(3) properly adjusted for realized capital gains or losses and other relevant items. |

# Glossary

| | |
|---|---|
| | Many of the terms that follow are defined as they pertain to section 809 of the Internal Revenue Code. |
| Admitted Financial Assets | Financial assets of an insurer permitted by a state to be taken into account in determining the insurer's financial condition. |
| Average Equity Base | The average of the equity base determined as of the close of the taxable year and the equity base determined as of the close of the preceding taxable year. |
| Average Mutual Earnings Rate | The percentage which the aggregate statement gain or loss from operations for the taxable year of domestic mutual life insurance companies is to the aggregate average equity base for such year. |
| Base Period Stock Earnings Rate | The average of the stock earnings rates for calendar years 1981, 1982, and 1983. |
| Current Stock Earnings Rate | The average of the stock earnings rates for the 3 calendar years preceding the calendar year in which the taxable year begins. |
| Deficiency Reserve | Addition to reserves of a life insurance company required by various states because the net premium is greater than the gross premium. |
| Differential Earnings Amount | An amount equal to the life insurance company's average equity base for the taxable year, multiplied by the differential earnings rate for such taxable year. |
| Differential Earnings Rate | The excess of the imputed earnings rate for the taxable year over the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins. |
| Earnings Rate | The percentage which the statement gain or loss from operations for the calendar year is of each company's average equity base for the year. |

Mr. Richard L. Fogel
September 14, 1989
Page Two

The draft states (p. 96) that "the companies favor this approach because the tax could be less visible to the policyholder." If some companies do favor the proxy tax approach, and GAO wishes to make this point, then the report should identify those companies. State Farm is not among this group.

We would be happy to respond to any further queries from you on these issues.

Sincerely,

Roger Joslin

Roger Joslin

jr

(section 808 dividends) were used and the amount of the proxy tax took into account the fact that dividends to pensions are not taxed. In addition, we believe that the formula should employ the shareholder dividend payout rate of 4.5 percent of equity used by the Treasury (Treasury Report, p. 40 n. 1) since it more accurately reflects the rate of dividends as a percentage of tax equity.

With these adjustments, we believe the GAO proposal would result in a proxy tax equal to 1.4 percent of dividends or, alternatively, an amount added to corporate income (or a dividend disallowance) equal to 4.2 percent of dividends. If the unnecessary step of translating equity returns into dividends is eliminated, additional corporate taxable income in the amount of about one percent of equity would be needed as a proxy for the policyholder level tax.

* * *

We appreciate the opportunity to provide these views on the draft report. We would be happy to provide any additional information that would be useful to them.

Ted Groom Matt Zinn

Theodore R. Groom Matthew J. Zinn

Counsel for Mutual Life Insurance Company Tax Committee

cc: Mr. Gandhi

independently, and in great depth. As part of its study, GAO has reviewed countless memoranda from experts and interested parties on the major issues related to section 809. Importantly, GAO and Treasury, two entities clearly neutral on stock/mutual issues, have reached the same conclusion.

B. Cost of Repeal Is Overestimated

Major revisions need to be made in the discussion of revenue cost (p. 70) because the estimate is based on incorrect assumptions. For example, the estimate is based on the years 1984-1987, which includes an artificially high differential earnings rate in the transitional year. Income figures for this period do not accurately reflect income for future years in which the differential earnings rate is expected to be relatively low as mutual and stock earnings rates grow closer together.

C. Equivalence of Stock and Mutual Policyholders

Mutual companies wholeheartedly support the conclusion that similar products issued by stock and mutual companies should be treated the same. Mutual companies also agree that, if dividends were used as the basis for applying a proxy tax, the definition of dividends contained in Code section 808 is the more correct measure of dividends. It is extremely important that any tax rules applicable to policyholder dividends apply equally to all forms of dividends.

D. Mutual Company Taxes Were Consistent With Income, 1984-1987

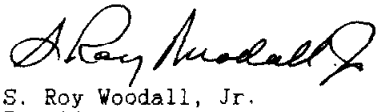
Mutual companies support the conclusion that during the period 1984-1987, mutual companies paid tax consistent with their income as defined by section 809. (p. 27) Table 2.2 of the GAO Report shows that for the period 1984-1987, mutual companies earned 42 percent of industry income and paid 45 percent of total industry taxes. (p. 27) There is, however, no reason to distinguish capital gains from the regular income of stock and mutual insurers, as is done in Table 2.2. Capital gains have been a consistent and substantial element of income for both stock and mutual companies during the 1980s and will continue to be so in the future.

E. Arbitrary Segment Balance Makes No Sense

The Draft Report concludes that, "correctly defining taxable income and then examining whether taxes split in accord with the income is a better way of determining if segment balance is achieved than applying some arbitrarily determined tax split." (p. 28) The Report concludes further that "alternative measures of segment balance" -- such as asset share and insurance in force -- do not "indicate[] what the proper allocation of tax should be, since none is a measure of income and the tax is an income tax." (pp. 27-28)

We appreciate the opportunity to review and comment on your draft report and urge your consideration of the points made in the comments of the Stock Company Information Group.

Very truly yours,

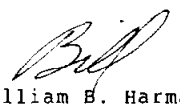


S. Roy Woodall, Jr.
President

The GAO's proposed recommendation should therefore be replaced with an approach that does not favor one segment of the life insurance industry over another and that is more responsive to the concerns expressed by Congress that mutual life insurers be taxed on their economic income so that tax revenues from the industry are both stable and fair. At the bottom line, such an approach should not increase the taxes of stock life insurers, and should provide for corporate taxes from mutual life insurers, in keeping with their economic income, at roughly the same level collected from stock companies. We have described several such approaches in our formal statement commenting on the draft report, which also indentifies a number of errors and instances of faulty reasoning in the draft report cited to support the report's flawed recommendation. These comments are attached. We also attach a diagram comparing the GAO's proposed recommendation with current law -- a diagram which shows the unbalanced, flawed nature of the recommendation's concept.

We appreciate this opportunity to comment, and anticipate that the final GAO report will reflect our views.

Respectfully submitted,



William B. Harman, Jr.

Attachments

# Comments From the Stock Company Information Group

Note: In the interest of brevity, we are not including the 80-page attachment. We have instead summarized the issues and discuss them at the end of the appropriate chapters.

LAW OFFICES OF

DAVIS & HARMAN

THE WILLARD

1455 PENNSYLVANIA AVENUE, N.W.

SUITE 1200

WASHINGTON, D.C. 20004

(202) 347-2230

September 7, 1989

Dr. Natwar M. Gandhi
Assistant Director
Tax Policy and Administrative Issues
U.S. General Accounting Office
1440 New York Avenue, N.W.
Washington, D.C. 20005

Re: Comments on the GAO Draft Report on the Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry

Dear Nat:

On behalf of the Stock Company Information Group, we are writing to provide our comments on the draft report of the General Accounting Office entitled "TAX POLICY: Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry." In that report, the GAO proposes to recommend that (1) mutual life insurance companies be allowed a 100 percent deduction for the dividends they pay to their policyholders, and (2) a "proxy" tax be imposed on the policyholder dividends of both stock and mutual life insurance companies.

We think that such a recommendation would be extremely unfair to stock life insurance companies and would be biased in favor of their mutual company competitors. It would increase Federal income taxes on stock life insurers, their owners, and their policyholders to approximately $3 billion per year while limiting the taxes on mutual life insurers and their policyholder-owners to roughly $800 million per year. Stock companies, which have about 40 percent of the life insurance industry's pre-dividend net income, would pay nearly 80 percent of the industry's total income tax.

We consider the proposed recommendation unreasonable for two principal reasons. First, it would relieve mutual life insurance companies of most or all of the corporate income tax by allowing them a full deduction for policyholder dividends. The GAO proposes to recommend this notwithstanding (and with no discussion of) the fact that (i) no other corporation is allowed a corporate tax deduction for distributed earnings,

Technical Comments on the GAO's Draft Report:
"TAX POLICY: Allocation of Taxes Between
Stock and Mutual Segments of the Life Insurance Industry"

1. Taxes Incurred by the Life Insurance Industry (pp. 15-7)

GAO's discussion of taxes paid by the life insurance industry inappropriately compares different tax measures. Tax revenues from the life insurance industry estimated at the time of the 1984 Act are tax after credits and after nonlife losses. The Treasury Department measure shown on Table 1.1, which is tax before credits and before nonlife losses, is inappropriately compared to the 1984 revenue estimates. The appropriate measure for purposes of this comparison is tax after credits and after nonlife losses. Table 1.1 should be changed to reflect these amounts, which are contained in Table 3.1 of the Treasury Department's Final Report to The Congress on Life Insurance Taxation (August 1989).

The draft GAO report also should note that its estimates of tax revenues, which are based on financial statement data, are not comparable to the tax statistics or the revenue estimates. The definition of the life insurance industry and the measurement of tax liability are different for tax and regulatory purposes. For a discussion of these points, see the Treasury Department's 1989 report, p. 19, and the Treasury Department's Interim Report to The Congress on Life Insurance Taxation (June 1988), pp. 35-7.

The draft GAO report also compares its estimate of tax revenues for 1987 to that estimated at the time of the 1984 Act. The 1987 estimate includes the effect of the Tax Reform Act of 1986, however, which was not included in the estimate made in 1984.

2. Objectives, Scope, and Methodology (pp. 18-20)

The use of financial statement data throughout the GAO draft report is problematic for the reasons noted above. The limitations of financial statement data are not described in the draft GAO report, although the use of these data raises methodological problems.

3. Segment Balance is Consistent with Measures of Mutual/Stock Income Split (p. 23-8)

Table 2.1 is incomplete because it excludes capital gains from income.

# Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

August 31, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

Thank you for the opportunity to provide comments on GAO'S draft report entitled "TAX POLICY: Allocation of Taxes Between Stock and Mutual Segments of the Life Insurance Industry."

The draft report examines section 809 of the Internal Revenue Code, which imputes income to mutual life insurance companies in order to tax at the corporate level equity-like returns inherent in policyholder dividends. Although section 809 was intended to equalize the tax treatment of mutual and stock life insurance companies, it has not succeeded. The draft report recommends the repeal of section 809 and also recommends that the Congress impose a proxy tax at the corporate level in lieu of taxing at the individual level the equity-like return inherent in the policyholder dividends of mutual and stock life insurance companies.

The Treasury Department's recent report to Congress on life insurance taxation also identified significant practical and conceptual shortcomings of section 809 and recommended its repeal (Final Report to The Congress on Life Insurance Taxation, August 1989). The Treasury Department's report also examined alternatives to section 809 including a proxy tax similar to that proposed by the GAO. Although the tax treatment of equity returns to investors (whether as shareholders or policyholders) mutual and stock life insurance companies could be made equal by imposing a proxy tax in lieu of an individual-level tax on the returns to participating policyholders, equal tax treatment also could be provided by removing the double taxation of shareholder dividends and thereby imposing tax at one level only. The Treasury Department believes that the latter approach is preferable because it reduces double taxation by providing partial integration of corporate and individual level taxes. (A shareholder dividends-paid credit to implement this approach is described below.) Moreover, the proxy tax creates practical difficulties in identifying and measuring returns to participating policyholders, particularly with regard to stock company participating policyholders.

In our calculations, we subtracted the paid-in capital of the subsidiary from the consolidated capital and surplus account. However, not knowing how much, if any, of the subsidiary's surplus was included in the parent's surplus, we did not subtract any measure of surplus from the consolidated capital and surplus account. As a result, our capital and surplus measures are overstated by whatever surplus of subsidiaries is included in the capital and surplus account of the consolidated firm.

## Earnings

We were able to calculate each firm's earnings from its financial statement. According to section 809, earnings are defined as:

Net gain from operations before policyholder dividends and federal income tax - policyholder dividends + realized capital gains.

This information was used to calculate an earnings rate for each firm. The earnings rate is the ratio of earnings to average equity.

With earnings rates for all of the firms in our sample, we were able to calculate average earnings rates for all of the mutual and stock companies and use these as estimates of average earnings rates for the segments. These calculations allowed us to compare the effects of weighted and unweighted averages on the results of the section 809 mechanism.

## Measuring the Company-By-Company Tax Burden

The earnings rates that we calculated for each firm allowed us to examine how the section 809 mechanism affected each mutual company. One major consideration is the importance of differential earnings and differential taxes in total earnings and total taxes for each mutual firm. For 1986, we used the measure of each firm's equity that we calculated and multiplied this by the relevant differential earnings rate in order to calculate differential earnings. Taxes equaled this amount multiplied by the relevant tax rate.

For 1985, we made similar computations; however, these calculations are not as complete, since we did not have all of the elements required for the calculations of equity for 1985. As a result, our company equity figures for 1985 relied on the ratio of equity to surplus from our 1986 calculations and multiplied this by each company's 1985 surplus.

One very important consideration in our calculations of company-by-company tax burden is the treatment of realized capital gains. As it turned out, the one year (1986) for which we had the most complete

defining a stock company, all stock life companies that are members of the same affiliated group are treated as one stock life insurance company. We included a total of 112 stock subsidiaries and affiliated companies, licensed in the District of Columbia, into the stock segment sample as part of the 50 consolidated companies.

These 50 companies controlled total assets of $261 billion, or 69 percent of the total assets controlled by the stock segment as of December 31, 1985. As of December 31, 1986, these companies controlled $306 billion—still 69 percent of segment assets.

## Construction of Life Insurance Data Base

Much of the information in our report is for the life insurance industry as a whole or for a particular segment. For many of the basic variables, we were able to rely on data provided by the Treasury. All of the relevant earnings rates for 1981 through 1986, as well as the average equity of the stock and mutual segments for 1984 and 1985, are contained in Treasury's Interim Report to the Congress on Life Insurance Company Taxation.

To calculate earnings and taxes for the mutual segment in 1986, a measure of that year's equity is required. Treasury had not gathered the relevant information for this calculation, and as a result, we had to construct an estimate from financial statements. In addition, to calculate earnings rates and other relevant measures firm by firm, we had to gather a detailed data set from the financial statements.

### Equity

The first step was to construct a measure of equity for each consolidated firm on the basis of information available on financial statements. The definition of equity for tax purposes is provided by section 809 of the Internal Revenue Code and includes:

- capital and surplus,
- nonadmitted financial assets,
- mandatory securities valuation reserve,
- deficiency reserve,
- one half of the amount provided for next year's policyholder dividends,
- the difference between statutory reserves and reserves for tax purposes, and
- voluntary reserves.

**Table I.2: Calculations of Earnings Rates, Amounts, and Taxes 1984 and 1986**

Dollars in Billions

| Step[a] | Description | 1984 | 1986 |
|---|---|---|---|
| 1. | Stock earnings rate for 1985 | | 18.683% |
| | Current stock earnings rate | | 17.983% |
| 3. | Imputed earnings rate | 16.500% (legislated) | 16.285% |
| 4. | Initial average mutual earnings rate | 8.700% (legislated) | 5.746% (1984) |
| 5. | Initial differential earnings rate (3 − 4) | 7.800% | 10.539% |
| 6a. | Estimated average equity | $33.800 | $38.400 |
| 6b. | Initial differential earnings amount (5 × 6a) | $2.600 | $4.100 |
| 7. | Average mutual earnings rate | 5.746% | 17.985% |
| 8. | Recomputed differential earnings rate (3 − 7) | 10.754% | 0[b] |
| 9. | Recomputed differential earnings amount (8 × 6a) | $3.600 | $0 |
| | Adjustment in taxable income (9 − 6b) | $1.000 | −$4.100 |
| 10. | Differential earnings taxes (.368 × 9) | $1.300 | $0 |

[a]Refers to steps in table I.1.

[b]The Internal Revenue Service has ruled that there is no negative differential earnings rate or differential earnings amount so that for 1986 the differential earnings rate is zero.

earnings rate that was 2 years old. The recomputation uses the actual mutual earnings rate for the year in question (step 4) but the same imputed rate as before (step 5). The recomputed differential earnings rate, also computed and announced by Treasury, is the following:

16.323 − 13.135 = 3.188 percent.

9. Recompute the differential earnings. Multiply the newly calculated differential earnings rate by each firm's average equity for the tax year in question.

Average equity for the mutual segment is still $34.1 billion, so the new differential earnings amount is 3.188 percent of the average equity, or $1.1 billion.

10. Recompute the taxes on differential earnings. Compare the new differential earnings amount with the previous amount (step 6). If the new amount is greater, add the difference to taxable income for the current tax year. If the new amount is less than the old, subtract the difference from taxable income. The effect on taxes will be the difference between the old and new differential earnings multiplied by the effective tax rate.

The recomputation, done in 1986, for 1985 involves a reduction in differential earnings from $2.1 billion to $1.1 billion. Taxable income for 1986 is reduced by $1.0 billion and taxes by $368 million. As a result net taxes on differential earnings are $773 million minus $368 million or $405 million.

Table I.1 summarizes the 10 steps to follow in computing differential earnings for 1985. Table I.2 shows the results of similar computations for the 1984 and 1986 tax years.

# Detailed Description of Section 809 Procedure

In chapter 1, we discussed the purpose of section 809 and outlined very generally the procedure for calculating the additional mutual company taxable income that results from that section. In brief, the procedure entailed computing differential earnings for each company by calculating a differential earnings rate and multiplying the rate by the company's average equity. This appendix presents a more detailed account of how the differential earnings amount is determined.

Differential earnings are meant to reflect the part of policyholder dividends that is a distribution of earnings to policyholders. Determining the proper amount is important because this amount is included in a company's taxable income.

The procedure for calculating differential earnings and the taxes on those earnings contains the following 10 steps, each illustrated with information relevant to the 1985 tax year:

1. Calculate the current stock earnings rate. This rate is an average annual earnings rate for the largest 50 stock companies covering the 3 years before the relevant tax year. It is calculated by the Treasury Department. For 1985, the computation included the earnings rates calculated for 1982, 1983, and 1984 and was as follows:

$(18.812 + 18.535 + 16.731)/3 = 18.026$ percent

2. Calculate the base period stock earnings rate. This rate, also calculated by Treasury, is an average of the annual earnings rates for the largest 50 stock companies for the years 1981 through 1983, as follows:

$(17.316 + 18.812 + 18.535)/3 = 18.221$ percent

3. Calculate the imputed earnings rate to be applied to the mutual segment. The imputed rate for a particular year is to be in the same proportion to 16.5 percent as the current stock earnings rate (step 1) is to the base period stock earnings rate (step 2). In effect, the law states 16.5 percent is the equivalent of a base period imputed rate for the mutuals. The imputed rate is announced by the Treasury. The computation, with x defined as the imputed rate, follows:

$$\frac{x}{16.5} = \frac{18.026}{18.221} \quad x = 16.323 \text{ percent}$$

mutuals were especially concerned that our measures of how much revenue our approach would have raised between 1984 and 1987 would be used to estimate future revenues. They also suggested that these amounts were too high.

We emphasize in our report that our estimates are not revenue estimates. We are not attempting to project what our proposal would generate in the future. Rather, we are measuring what would have been generated under the conditions that held between 1984 and 1987 if our proposal had been in effect. Even if we were able to give a rough indication of what our proposal might generate in the future, we cannot estimate what section 809 would have raised.

In their comments the mutuals suggest a tax which, in our opinion, is too low. They are making adjustments for taxes already paid on policyholder dividends that we believe are overly generous. Both the mutuals and the Treasury are basing their proxy taxes on a dividend payout rate by stock companies of 4.5 percent of equity. As discussed in this chapter, we believe that the proper rate would be closer to 6 percent. There are also differences in how the mutuals and we calculated the tax rates and tax base. As a result, the tax we suggest will be higher than that suggested by the mutuals. Whether it is higher than what would have been earned under section 809 is not certain. We were more concerned in our analysis with taxing participating policies more equitably than with exactly offsetting the revenue loss that would result from deleting section 809.

Hence, we believe there is no competitive advantage generated by the prepayment approach to either segment of the industry.

The second point is based on the stock companies' contention that if the government discount rate is below the private sector rate of return, the present value of taxes paid by stock companies would exceed that paid by mutuals. From a computational standpoint this is true, and we state it in our report (See p. 43). However, jumping from this to the conclusion that the prepayment approach is inappropriate is not justified. The government discount rate might be lower than the private sector rate of return for a number of reasons. The most important is that the government does not have to pay a risk premium. In addition, it may be lower for certain social reasons that are beyond the scope of our analysis. To use a low government discount rate too mechanically would lead to the conclusion that the government should not collect taxes from anyone whose rate of return exceeds the government's discount rate, or that it should make additional funds available to these firms because that would increase the present value of tax revenue. We do not believe this is the proper use of a government discount rate.

## The Tax on Policyholder Dividends Should Be Imposed on Mutuals Only and Should Not Include Excess Interest

The stock groups and State Farm Life are both strongly opposed to applying the tax to policyholders of stock companies. Their argument is that, since the shareholders of a stock company are the only owners, and therefore the only ones who can receive an equity return, there is no basis to extend a policyholder dividend tax to stock companies. The stock companies also argue that while excess interest is legitimately considered a policyholder dividend, it simply reflects a market sensitive interest factor and not a return on equity. They claim that the excess interest is part of the inside buildup on life insurance products that has traditionally gone untaxed until surrender of the policy.

The mutuals would like to see stock companies pay a tax on dividends paid to policyholders and on as broad a base as possible. Treasury indicates that stock companies, certainly those that sell participating policies, distribute a return to their policyholders, and Treasury would tax it as well.

As discussed in this chapter, it is our belief that the policyholders of stock companies who receive dividends on their policies also receive a return on equity. This is clearly the case for participating policies that are indistinguishable from those sold by mutual companies. It may be

terms as equivalent income of stock companies. Consequently, the primary issue concerns the equity generated through excess premiums.

The excess premium, to the extent it is not used to cover expenses, is available to add to the surplus of the mutual company. This surplus serves as the cushion against hard times or periods of bad insurance experience that is one of the main purposes of equity. Whatever it is called, it is an amount that adds to the financial resources of the company. Dividing these resources into debt and equity is always subject to some arbitrary distinctions. The same is true of the amount paid to a life insurance company under a participating policy. For mutuals and for some stock companies, some amount of the premiums received will always function as a contribution to equity.

The stock groups contend that even if the redundant premium exists and even if it represents an equity contribution it was not fully taxed when the contribution was made. They maintain that mutuals were generally not taxed on underwriting income before 1984. Thus, excess premium did not enter the tax base. After 1984, they argue that large upfront expenses plus preference income have sheltered premiums from taxation. In addition, the section 809 formula shelters premiums by reducing the dividend disallowance dollar for dollar.

We agree with the stock groups that excess premiums received by mutuals were not subject to full taxation prior to 1984. During the period 1959 to 1983, however, policyholder dividends were not fully deductible, so the income generated by the excess premiums was taxed. As best we can determine, policyholder dividends were taxed, on average, at about the same rate over that period as they were between 1984 and 1987. While this does not demonstrate that equity was fully taxed, it does suggest that the returns on equity were taxed more than minimally. There may still be some untaxed or undertaxed equity remaining from before 1959 or generated between 1959 and 1984, but it would be very difficult to measure it with any precision. Taxing old equity that was undertaxed could also generate a disadvantage to the mutuals on new business.

Since 1984, underwriting income has been in the mutuals' tax base. The existence of high initial expenses or tax-preferred income is not relevant to the prepayment approach. Excess premiums would add to underwriting income, making it larger or losses smaller, and add to taxes. This is all that is necessary for the approach to be valid.

comparable treatment of stock and mutual companies. This will entail some calculation and designation of a part of policyholder dividends as taxable earnings.

## Recommendation

We recommend that Congress delete section 809 from the tax code, accept the prepayment approach at the company level, and legislate a tax on the earnings part of dividends attributed to the individual policyholder. Congress should impose the tax on these earnings at the company level as a proxy for the tax on individual policyholders.

To calculate the earnings part of policyholder dividends, we recommend that Congress specify a proportion of policyholder dividends to be included in the taxable income of mutual and stock life insurance companies. This proportion should be based on the dividend payout behavior of stockholder-owned corporations but could be adjusted upward to allow for capital gains. The proportion should be reexamined periodically.

## Treasury and Industry Comments and Our Evaluation

We received a mix of favorable and unfavorable comments on our draft report from the Department of the Treasury as well as from various parties within the insurance industry. Treasury noted that an August 1989 report it issued to Congress[18] also identified significant practical and conceptual shortcomings of section 809 and recommended its repeal. However, Treasury's preferred remedy differed from ours. The Stock Company Information Group commented that our recommendations were unreasonable and extremely unfair to stock life insurance companies, and the National Association of Life Companies urged us to consider the stock group's comments. The Mutual Life Insurance Company Tax Committee found our study to be thorough and impartial, said that mutual companies support most of our draft's major findings, and suggested refinements in our recommendation for a proxy tax. One mutual company, the State Farm Mutual Automobile Insurance Company, whose life insurance subsidiary State Farm Life is taxed as a stock company, agreed with us that section 809 does not follow a pattern normally associated with income taxes. It did, however, find our proxy tax recommendation very troubling.

Elaboration on specific major comments we received and our evaluation of them follow.

[18]Final Report to the Congress on Life Insurance Taxation, August 1989.

much of the dividends received by policyholders is a distribution of earnings.

Keeping section 809 but adjusting it by moving to an unweighted average in the calculation of the mutual earnings rate would reduce the effect of actions by large companies on that rate and therefore on the taxes of the other companies. Changing the average mutual earnings rate to a 3-year average and updating that and the imputed rate would reduce the uncertainty over tax liabilities arising from the continual need for recomputation. However, none of these changes would affect the regressivity problem or the concern that good mutual years will be associated with lower differential earnings. The 3-year average would simply smooth the effects of these problems over time.

One method we discussed would substitute a municipal bond rate for the stock earnings rate as a basis for imputation. This method would avoid the problems of using a stock earnings rate. If a weighted average mutual earnings rate is maintained, the problem of large companies affecting the taxes of everyone else would remain. It would not solve the regressivity problem or the problem of good mutual years being associated with low differential earnings and bad years with high differential earnings.

Both the Aaron alternative discussed in the text—using the municipal bond rate as a measure of earnings paid out by mutuals—and the tax on a designated proportion of policyholder dividends deal with all of the problems except regressivity. Any tax that includes an amount in taxable income that is not directly related to a company's earnings experience is likely to be regressive to some extent.

The alternative which uses a bond rate to measure the proportion of earnings distributed will impose an amount that can be too high or too low depending upon what any particular company has paid out to its policyholders. The tax on a designated proportion of policyholder dividends can impose an amount that could be based on either the average difference between an imputed rate and a mutual earnings rate or the dividend payout rate of stock companies. If a particular mutual is paying out earnings at a lower rate, then it will be "overtaxed." The tax on policyholder dividends has the advantage that taxes on distributed earnings would rise and fall with policyholder dividends.

Several of the alternatives discussed—Graetz's prepayment approach and the two approaches that use a municipal bond rate—would have

**Table 3.2: Proxy Taxes Based on 25 Percent of Policyholder Dividends**

Dollars in Millions

| | | Personal tax rate | | |
|---|---|---|---|---|
| **1984** | **Differential taxes[a]** | **15 percent** | **20 percent** | **28 percent** |
| Mutuals | $1,338 | $236 | $315 | $441 |
| Stocks | 0 | 64 | 86 | 120 |
| **1985** | | | | |
| Mutuals | 400 | 251 | 335 | 468 |
| Stocks | 0 | 75 | 100 | 140 |
| **1986** | | | | |
| Mutuals | 0 | 243 | 324 | 454 |
| Stocks | 0 | 84 | 112 | 156 |
| **1987** | | | | |
| Mutuals | 1,284 | 253 | 337 | 472 |
| Stocks | 0 | 88 | 118 | 165 |
| **1984-87** | | | | |
| Mutuals | 3,022 | 983 | 1,311 | 1,835 |
| Stocks | 0 | 311 | 416 | 581 |
| **Total** | **$3,022** | **$1,294** | **$1,727** | **$2,416** |

[a]Estimated.

In addition to being dependent on the tax rate used, the amount of revenue collected under these alternatives would also have depended on the proportion of dividends considered income. The 25-percent designated proportion shown in table 3.2 would have raised less revenue than that raised by section 809, even with a 28-percent rate and the inclusion of stock company policyholder dividends. To have raised the same amount of revenue would have required a tax rate closer to 35 percent or an inclusion proportion of over 30 percent. If the proxy tax rate is reduced, revenue will fall unless the designated percentage is increased.

The calculations in tables 3.1 and 3.2 were made using policyholder dividends as reported on financial statements. The definition of policyholder dividends for tax purposes is broader and includes, in addition to the standard policyholder dividends paid on participating policies, excess interest, premium adjustments and experience-related refunds. To be consistent with our earlier discussion of the tax treatment of individual policyholders, any item that represents a cash payment to policyholders or which allows the policyholder the option of taking payment in cash or reduced premiums as part of the dividend distribution process could be included in the definition of policyholder dividends for the purposes of this calculation. Thus, the definition would include premium adjustments but would not include experience-related refunds paid on group

should be distributing earnings at similar rates. These payout rates are equivalent to about 25 percent of policyholder dividends.

The total amount of revenue that would have been collected from the mutuals under the 20-percent option is about the same as that raised by the tax on differential earnings for 1984-87, although the tax revenue from the stocks is greater since they do not currently pay such a tax. The primary difference for the mutuals would be that the actual revenue ranged between $0 (1986) and over $1 billion (1984), while dividends changed only gradually, and the revenue generated from a tax on 20 percent of mutual dividends would also have changed only gradually over the period (from a low of $662 million to a high of $770 million).[16]

The highest designated rate in the table is 40 percent. If realized capital gains had not occurred over the period, the resulting earnings rates would have led to differential earnings that were about 40 percent of policyholder dividends. If, in the future, realized capital gains are a less dominant part of mutual company income and gains from operations do not increase, this proportion is likely to be a better approximation of the ratio of differential earnings to policyholder dividends. If a 40-percent inclusion proportion had been in place between 1984 and 1987, tax revenues collected from the mutuals would have increased by about $2.6 billion. In addition, tax revenues would have been higher, by an amount that depends on the proportion chosen for stock companies if their policyholder dividends had been subject to such a tax.

The 25-percent proportion has the advantage of being independent of all of the problems associated with section 809 or any imputation method that calculates a differential measure of distributed earnings. Because it is related directly to the payout behavior of shareholder-owned corporations, it does not require the computation of a differential earnings rate or an average mutual earnings rate. The question of using weighted versus unweighted measures of this rate is therefore avoided. The measure is also taken from the payout behavior of all shareholder-owned corporations and not just stock life insurance companies. It could thus reduce the effect that one segment of the life insurance market on the other.

For these reasons, this approach may be preferred to the differential approach. The revenues, of course, fall between the other two measures, since the proportion included is between the other two measures.

[16]The 1987 figures are somewhat higher because the effective tax rate rose to 40 percent for life insurance companies.

effective premiums in the future. Similar arguments therefore hold for there being a return on equity included in the policyholder dividends. A question arises, however, as to whether all of the return on equity gets paid to policyholders, since some could be siphoned off to shareholders and picked up as regular income. Currently, those dividends paid to policyholders by stock companies are not taxable at the company level and are taxable at the individual level only when the sum of dividends is greater than the sum of premiums.

For consistency's sake, an argument can be made that some proportion of the policyholder dividends of stock companies should also be subject to taxation. This is not possible with the imputation methods, which use rates of return applied to some equity base as a way of measuring income. These methods require an equity base that can be assigned to policyholders for the purpose of designating the earnings paid out as policyholder dividends. Any attempt to isolate the amount of a stock company's equity that is stockholder equity from the amount that is policyholder equity for the purpose of making such a calculation would be arbitrary. A tax on a proportion of policyholder dividends does not require such a division.

## How Would Such a Tax System Work?

There are a number of ways to determine the proportion of policyholder dividends that should be included in income, whether the company's or the policyholder's. We have used two methods for arriving at this proportion in order to give an indication of the magnitudes involved. In addition, since the tax can be a company or a policyholder tax, or both, we have attempted to measure the revenue implications of including particular proportions of dividends in income subject to corporate or a range of alternative personal tax rates. These revenue measures are based on the policyholder dividends that were paid by mutual and stock companies as reported on financial statements. They do not represent revenue estimates and, in particular, do not attempt to model any changes in company behavior in response to a tax change.

Table 3.1 describes the effect of including different proportions of policyholder dividends in the taxable income of mutual and stock companies. The proportions selected, for reasons explained below, are 20, 25, and 40 percent for both stock and mutual companies.[15]

[15]In the 1982 tax act, stock companies had a lower percentage of dividends included in income than did mutuals. This was to reflect payment of dividends to shareholders. A similar adjustment could be made under this proposal.

there was some evidence that mutuals were paying out more as a group, and the proportion was changed to reflect this.

The second difficulty—that the proportion of dividends determined by law to be a return on equity will only be appropriate for an "average" firm—will exist any time a tax is based on an average for the industry rather than on individual company performance. One concern expressed about the tax on policyholder dividends is that it will generally not take into proper account the product mix of different mutual life companies.[13] Companies that sell products that have a lower proportion of return on equity included in policyholder dividends will be at a disadvantage compared to companies with a higher proportion, since both sets of companies will be taxed as if their products contained the same equity return in policyholder dividends. Stated another way, companies will have an incentive to alter their product mix away from the low return on equity and toward the high return on equity products for tax reasons. This means that the tax will not be neutral in its economic effects. Unless there is a good reason to favor one type of activity or product over another, effective tax policy should have as little effect on the amount of output or the mix of output as possible.

While a tax on a proportion of policyholder dividends has this drawback, it has become clear that the other imputation methods have problems of their own. It may be true that any proportion of policyholder dividends that might be stated in the law need not reflect what any given company is paying out as earnings, but as was demonstrated in chapter 2, the differential earnings rate—or its equivalent—need not reflect the rate of return on equity that a particular firm is paying out. To repeat, the differential tax is also a tax on policyholder dividends, but the proportion subject to tax changes from one year to the next and in a manner such that differential taxes are high when earnings after dividends are low and vice versa.

The degree of regressivity by company and by year would be reduced under this alternative. From table 2.3, we know that the ratio of differential earnings to policyholder dividends ranged from about 27 percent for the high-earnings companies to about 46 percent for the low-earnings companies in 1985. For 1986, the range was from 46 percent for the high-earnings companies to 83 percent for the low-earnings companies.

[13]Different products, such as group pension policies and variable life policies, have different elements of return on equity in them. If all companies had the same mix of products, a given proportion would fit all. However, this is not the case.

method, a tax on the policyholder could still be instituted under this alternative.

The basis for choosing the proportion of dividends to be designated can be the stock life insurance company earnings rate as in section 809, an economywide stock company return on equity, a tax-free bond rate as in Aaron's approach, or some measure of stockholder dividends paid by stock companies.[11] Regardless of the way the rate is chosen, the designation option permits the taxation of a part of the policyholder dividends paid out by stock as well as mutual life insurance companies.

The Tax Equity and Fiscal Responsibility Act of 1982, which provided an interim basis for taxing the life insurance industry between the 1959 and 1984 acts, limited the deductibility of policyholder dividends for mutual companies to 77.5 percent of those dividends paid. That is, 22.5 percent of policyholder dividends were included in taxable income. In addition, the 1982 act limited stock companies to deducting 85 percent of their policyholder dividends.

## Difficulties in Designating a Proportion of Policyholder Dividends as Taxable Income

One of the basic concerns about a tax on some stated proportion of policyholder dividends is that it is an arbitrary tax. It is not a tax on income but only on some approximation of income; however, any of the taxes on mutual companies or on earnings at the policyholder level that have been discussed have the same limitation because they all are based on approximating income.

In general, a tax on a designated proportion might be considered inappropriate for two reasons. First, the part of dividends included in taxable income, as a proportion of average equity, may not reflect the actual return on equity paid out to policyholders by the average mutual life company. Second, even if on average it were correct, the proportion chosen may not reflect the actual return for a particular firm.

The first difficulty could be mitigated by tracking the measure that forms the basis for the designated taxable proportion and making adjustments. For example, if the measure used were stockholder dividend payouts, the proportion of dividends could be adjusted every 3 to 5 years to keep it in accord with the ratio of stockholder dividend payouts to policyholder dividend payouts. A correction such as this would allow

[11]The dividend payout rate would be the ratio of shareholder dividends to equity for some set of stock companies, life insurance or otherwise.

the bond rate as a measure of only the part of company income that was distributed, rather than as a measure of the distributed and the undistributed return.

In the first approach, the imputed rate would be a proxy for the total rate of return earned on a mutual company's equity. The average mutual earnings rate would measure the rate of return that was retained by the company. The difference between the two rates (currently called the differential earnings rate) would measure the rate of return that was distributed to policyholders in the form of dividends. This approach would differ from the current section 809 only in its use of a different imputed rate.

For the period 1984 through 1986, the imputed rates under this system were lower than those that resulted from the section 809 calculations (after removing realized capital gains). As a result, the differential earnings and differential taxes would have been lower under this system than under the section 809 approach. The total tax revenue loss would have been about $800 million for the 3-year period 1984 through 1986.

The second approach is to compute and apply the imputed bond rate, as Aaron suggested. Instead of applying the imputed rate to equity as a measure of the total return on equity, however, Aaron suggested applying the rate to a mutual company's surplus as a measure of the rate of return that is distributed to policyholders. The rate used to measure the distribution of earnings is higher than in the previous case but the base to which it applies (surplus as opposed to equity) is smaller. As a result, the amount of revenue can be larger or smaller. For the period 1984 to 1986, tax revenue would have been lower than under the current system or under the alternative that uses the tax-free bond rate as a total return to equity.

The primary difference between these approaches and section 809 is that they do not use the performance of the stock segment to measure the performance of the mutual segment. They thus overcome one of the problems discussed in chapter 2. As a result, if stock life companies have above-average earnings, mutual companies will not necessarily have above-average taxes, although if mutual life companies lag behind (or outperform) the economywide rate of return chosen, they could be overtaxed (or undertaxed). However, this outcome will result from any imputation scheme, since no imputed rate is likely to track the earnings rate of mutual life companies exactly.

An additional consideration is total revenue. This alternative does not base the recomputation on the actual 1-year average mutual earnings rate, but on an updated 3-year average. Therefore, the amount of earnings that are recomputed and the taxes on them will differ as the 3-year average earnings rate differs from the actual mutual earnings rate. If the actual rate is below the 3-year average, then the calculated differential earnings rate will be reduced by using the average, as will tax revenue. The opposite would occur if the actual rate is above the average. Using a 3-year average would have raised less total revenue over the period 1984 through 1986, since mutual earnings rates fell over that period.[8] In this case, smoothing out the fluctuations would come at a cost.

## Updating the Imputed Rate

Since the basis for the imputation method of section 809 is an assumed correlation between the earnings rate of the stock and mutual segments, an accurate measure of the differential earnings rate in a particular period calls for the use of the most recent information on both segments. Under section 809, the calculation of recomputed earnings uses the actual mutual earnings rate for the relevant tax year, but it carries over the imputed rate from the initial computation. The recomputation is based on updated mutual information but not updated stock information. If the stock and mutual rates do move together, fluctuations will be smoothed over time and a better picture of differential earnings will be drawn by also using an updated measure of stock segment performance. If the rates do not move together, updating may lead to substantially less smoothing, that is, more fluctuations.

There are many ways to accomplish this updating. Some methods would emphasize updating at the expense of smoothing. The one that we present combines updating and smoothing. Our method uses an updated 3-year average to calculate the imputed rate, which we pair with an updated 3-year average mutual earnings rate. For the period 1984 through 1986, the amounts involved in recomputation, using this approach, would have been reduced substantially, from $1,206 million to $359 million, if realized capital gains are ignored.

However, the revenue loss would have been over $1 billion. Again, the revenue loss reflects the fact that the updating takes into account the most recent stock information. The stock earnings rates over the period

[8]The calculations in the text are done without including realized capital gains. Since these gains were very important in 1985 and 1986 and they served to raise the average mutual earnings, they would have caused tax revenues to be higher had a 3-year average been employed.

With an unweighted average mutual earnings rate, a company that lowers its own earnings rate by paying more dividends will have little effect on differential earnings and taxes. As a result, its taxes will be lower and its competitor's taxes will be slightly higher. The government will definitely lose tax revenue from any increases in policyholder dividends that might take place under an unweighted average.

In addition, the use of an unweighted average could aggravate the regressivity of the tax system. This would occur if the larger companies have, on average, higher earnings rates after policyholder dividends. Switching to an unweighted average would reduce the influence of high earnings companies, lowering the measured average mutual earnings rate. This would raise the differential earnings rate and make the system more regressive. For 1985 and 1986, switching to an unweighted average would have slightly increased the differential earnings rate, at least when realized capital gains are included. Whether this would continue to be true for other years is uncertain.

Switching to an unweighted average mutual earnings rate will solve one problem with section 809 but may introduce or exacerbate others. If it is necessary to calculate an average mutual earnings rate, it may also be necessary to accept the flaws of the weighted average approach.

## Otherwise Altering Section 809

Section 809 uses a method of imputation based on the earnings rate of a sample of stock life insurance companies. However, the precise method that it uses includes a number of moving averages and recomputations, any of which could be different. We examined a number of alternative ways of adjusting the 809 procedure to see if they would reduce the amount of income and taxes subject to recomputation and, as a result, the uncertainty about tax liabilities as described in chapter 2.

The alternatives address specific questions about the section 809 procedure and the size of the fluctuations in tax computations that they cause.

- Why is the average mutual earnings rate based on 1 year's earnings, while the current stock earnings rate is based on 3 years' worth of earnings data?
- Why is the average mutual earnings rate updated for the purpose of recomputation, while the imputed rate (from which the mutual earnings rate is subtracted) is not?

If the prepayment method is adopted, it will be hard to isolate what has already been taxed from what has not. For instance, it will be difficult to tax only that part of policyholder dividends attributable to untaxed or undertaxed premiums from before 1984, but not to tax those dividends attributable to premiums paid in 1984 and afterward. Fortunately, it does not appear that the amount of untaxed equity is very significant. By our calculations, the average dividend disallowance over the period 1958-83 was about 25 percent, similar to the 21-percent average disallowance over the period during which section 809 has been in effect. Even though there may have been some undertaxation of the mutual segment in the 1960s, the overtaxation that occurred during the 1970s seems to have compensated for it. Even if the excess premiums were not fully taxed, the taxation of policyholder dividends over the period appears to have ensured that little mutual equity has escaped at least some taxation.

## Competitive Balance Requires Taxing Policyholders

The prepayment method only examines the taxation of mutual life insurance companies from the standpoint of the company tax. In the Graetz example, the return paid to stockholders and to policyholders was the same after the company tax. However, many stockholders also pay personal income taxes on the dividends they receive. Policyholders, however, do not generally pay tax on their dividends, even though at least some portion is income.[4] Thus, the participating life insurance policy issued by mutual and some stock companies has a potential competitive advantage.

There are two apparent reasons for exempting policyholder dividends from the personal income tax. The first is that no part of these dividends was ever treated as income for tax purposes before 1982, and no attempt was made to measure the income content of these dividends until 1984. The second reason is that investment income generated by life insurance policies has never been taxed at the personal level as long as the income remained "inside" the life insurance policy. This is the special tax treatment of what has become known as inside buildup.

The reasons for exempting policyholder dividends from the personal income tax may no longer be valid. First, even though it may not be completely successful, a system is now in place for approximating the

[4]Policyholders will pay tax on policyholder dividends only when the total amount of dividends paid out exceeds the total amount of premiums paid into the policy. If this occurs, it is usually late in the policy's life and still involves a large amount of postponement of paying taxes.

## Using the Actual Rate of Return as the Discount Rate

The Graetz theory assumes that the present value of tax payments by stock and mutual companies will be equivalent, if mutuals are allowed full deductibility of dividends; however, they may not be for each firm or in every year. The prepayment analysis assumes that the present value of the stream of returns (after taxes) is always equal to the initial amount invested (after taxes). This will be true only if the stream of returns is discounted by the actual rate of return earned by the amount invested. If a different interest rate is used for discounting, the present value of the stream of returns will not be equivalent to the amount invested.

Since firms do not know what the actual rate of return is going to be, they will discount future returns on the basis of an expected rate of return. If the actual rate of return is equal to the expected, and therefore equal to the discount rate, the prepayment analysis is correct. If the actual is not equal to the expected, some concerns arise.

To demonstrate this point, we will use Graetz's example, but with one change. Suppose that instead of earning a return of $20 per year, the stock company's investment turned out much better than expected, and the return was $40 per year. With a tax rate of 35 percent, company taxes would be $14 per year and the return for its shareholders $26 per year. A mutual facing the same situation would receive its $100 in capital contribution and pay the tax of $35 on that contribution. The return generated by its $65 net investment would be $26, the same as the return after taxes received by the shareholder of the stock company. Under the prepayment method, if both investments earn the same return before taxes, the return after taxes is also the same and neither is favored by the tax system.

In this case Graetz would argue that the initial $35 paid in taxes by the mutuals is equivalent, in present value terms, to $14 per year paid by the stock company. Yet, in the earlier example, $35 was equivalent to $7 per year paid by the stock company. The difference is that while both companies are earning a higher-than-expected return, the stock company is paying tax that reflects that higher return. On the other hand, the mutual company is paying the same actual tax as it was in the previous case—$35. Its tax is higher only in the sense that this $35 would have generated $14 at a 40-percent rate of return rather than $7 at a 20-percent rate of return. So, while the actual amount that the mutual pays is the same, the potential earnings that the company forgoes by paying taxes up front is higher with a greater rate of return.

argument is countered by the fact that, for the mutual life insurance policyholder, there is an extra return if the company performs better than expected; similarly, there is a reduced return (which could turn negative under extreme circumstances) if the company consistently performs weakly. So, while the measurement of the return on equity is still not resolved, there is an economic basis for saying a return on equity exists.

Michael J. Graetz of the Yale Law School has proposed a second argument for concluding that maintaining competitive balance between stocks and mutuals does not require an additional company-level tax on the income that mutuals distribute to policyholders, that is, that the rationale for section 809 is not firmly based. This argument does not deny that there is a return on equity paid by mutual life insurance companies to their policyholders. It does argue that, if all of a mutual company's premiums—including the excess premiums that are one source of a company's equity—are part of taxable income when they are paid in, a tax on the return on equity when it is paid out as policyholder dividends is not necessary to maintain competitive balance.[3]

The basic assumption of Graetz's approach is that mutual companies include in underwriting income, which is one component of taxable income, something that most stock companies do not include—contributions to their capital. In chapter 1, we distinguished between participating policies (sold predominantly by mutual companies) and nonparticipating policies (sold predominantly by stock companies). The mutual companies generate new capital by selling participating policies, which include an excess premium that is a contribution to capital. If this excess premium is included in the company's taxable income, the contribution of capital is subject to tax. Graetz argues that the company is "prepaying" taxes. When stock companies receive new capital from their shareholders by selling new shares, they pay no taxes on it.

If mutual companies pay taxes on capital contributions when they are received, the Graetz argument leads to the conclusion that they should not have to pay an additional company-level tax on the income generated by those capital contributions (returns on the amount invested). Paying this additional tax, such as the differential tax imposed by section 809, would amount to double taxation.

[3]Michael J. Graetz, "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential," Life Insurance Company Taxation: The Mutual vs. Stock Differential, Michael J. Graetz, ed. (Larchmont, N.Y.: Rosenfeld, Emanuel, Inc., 1986).

## Including All Policyholder Dividends in Taxable Income

Of all the alternatives considered in this chapter, the one with the largest tax base includes in taxable income all policyholder dividends paid out by the mutuals. This alternative treats the dividends as if they were only a return on equity. Since some stock companies also issue participating life insurance policies, they also pay out policyholder dividends and they would also be subject to any tax on these dividends. To the extent that these dividends include a repayment of excess premiums or capital contribution, under this alternative the tax base for mutual companies and stock companies selling participating policies would include items not normally considered income. All of the problems raised by section 809 would disappear because there would be no need for a mechanism to isolate different components of policyholder dividends.

A tax on all policyholder dividends would have raised an estimated $3.5 billion annually from the mutual companies from 1984 through 1987, if dividend payout behavior remained unchanged. This is more than four times the revenue that was generated by the taxation of differential earnings (estimated to average about $750 million per year). In addition to what could be raised from mutuals, an additional $1 billion would have been generated from the stock segment under similar assumptions regarding time frame and payout behavior.

## Excluding All Dividends (Policy and Stockholder) From Taxable Income

Another extreme alternative would also overcome the problems brought on by section 809 by abolishing the need for it. This alternative would not include any dividends in the taxable income of stock or mutual companies. Stock companies, whose stockholder dividends are now included in their corporate tax base, would be taxed only on earnings that are not distributed. For consistency's sake, mutual companies would be treated the same way. If all companies are allowed to deduct dividends paid, whether to stockholders or to policyholders, the problem of measuring the return on equity that is distributed by mutuals to impose a tax on the company becomes irrelevant. In effect, both stocks and mutuals would be taxed only on the earnings that are retained (not distributed).

Various organizations and individuals have suggested proposals to allow all corporations to deduct dividends from taxable income. The argument underlying these proposals is that since individuals are taxed on dividends they receive from corporations, the "double burden" of also taxing the dividends at the corporate level reduces incentives for saving and capital formation. In 1984, the Department of the Treasury suggested excluding from the corporate tax base half of the dividends paid

measures to include these gains. For example, tables 2.1 and 2.2 now include realized capital gains.

Treasury also criticized our discussion of regressivity for ignoring realized capital gains. One problem we found with including realized capital gains during the 1984 to 1987 period is that the very large realizations in 1986 tend to skew the results. Our data set of individual firms was primarily from 1986. As a result, using the actual earnings rates would have implied a differential earnings rate and corresponding differential tax of zero. While this is what actually occurred in 1986, it does not give us any insight into how the tax was distributed in those years when the differential earnings rate was positive. Since the purpose of our analysis was to measure the distribution of the tax burden, we constructed a hypothetical distribution based on earnings rates without capital gains. Everything else was the same as the 1986 data would imply, only the differential earnings rate was changed by our calculations.

company would have to raise its own earnings rate to raise the taxes of the mutuals. Raising its earnings rate would cause its own taxes to rise directly but would only cause the mutual segment's taxes to rise by some fraction. This is because the effect of one company on the stock earnings rate depends upon its weight in the determination of that rate. Since the stock earnings rate is an average of 50 stock companies, all having the same weight, the effect of any one company on the average is 1 in 50. For example, if a firm were to raise its own earnings rate by 1 percent, the average stock earnings rate would go up by only 0.02 percent.

## Conclusions

Through 1987, the mutual-stock split in taxes produced by the section 809 approach was consistent with the mutual-stock split in income, at least under the definition of income implied by section 809, which includes realized capital gains. If a standard different from that embedded in the law had been used, this consistency might not have occurred.

Even if section 809 generated approximate balance for the mutual segment compared with the stock segment, problems and concerns would arise company by company and year to year.

The most obvious problem associated with section 809 is its regressivity, which takes two forms. The first results when companies with below-average earnings have to pay above-average differential taxes. The second occurs when the mutual segment has a below-average year, but it has to pay above-average differential taxes. The first form of regressivity is inherent in any imputation scheme that relies on averages. The second will occur with any system that uses the differential earnings approach. This approach involves subtracting one earnings rate from another. If these two rates do not move in tandem, the differential rate will be low when the mutual earnings rate is high and vice versa. Chapter 3 suggests ways of mitigating both of these effects.

In addition, the use of a weighted average in computing the mutual earnings rate generates problems because it gives large mutual companies significant influence over the taxes paid by other mutuals. This influence is important whether or not it is used strategically by the larger companies.

One building block of the section 809 computation is the use of average stock earnings rates as a basis for calculating the imputed rate of the mutual segment. While there is some rationale for this choice, the use of

could be drawn from the data.[16] However, recent empirical study has attempted to demonstrate that firms switching from stock to mutual suffered no loss in efficiency.[17] Studies on both sides of this issue are only suggestive since, without directly observing a mutual company's rate of return (including earnings retained and distributed), there is not likely to ever be conclusive evidence that the average mutual company earns a lower return (or for that matter a higher return) than a similarly situated stock company.

The other reason for expecting the earnings rate of a mutual company to be below that of a stock company is that the dividends paid to a stock company's shareholders are taxable under the personal income tax, while dividends paid to policyholders are only taxed when the sum of dividends exceeds the sum of premiums or when the policy is surrendered. As a result, the shareholder will require a higher rate of return (before personal taxes) if the shares are to be competitive with the mutual life policy as an investment vehicle. A counterargument exists, however, that because a mutual insurance policy cannot be bought and sold in a secondary market, investors would normally demand a higher return to be willing to buy such an asset. The issue of not taxing policyholder dividends at the personal level is discussed in more detail in chapter 3.

The evidence concerning the relative rates of return earned by stock and mutual companies is not clear-cut. Chapter 3 discusses a number of alternatives that either do not use the stock life insurance companies as a basis for imputation, or use only the rate of distributed earnings for that imputation.

## What If There Is No Close Correlation Between the Stock and Mutual Rates of Return?

Section 809 assumes a very close correlation between the movement of the stock earnings rate and what would be the equivalent mutual earnings rate (including earnings retained and distributed) if we could observe it. However, this may not be the case, and if the correlation is not close, taxing mutuals as if they are doing well when the stock companies are in fact doing well may lead to inappropriate results.

[16]See R. Spiller, "Ownership and Performance: Stock and Mutual Life Insurance Companies," Journal of Risk and Insurance, vol. 34 (1972), and M. O'Hara, "Property Rights and the Financial Firm," Journal of Law and Economics, vol. 24 (1981) for discussions of the efficiency of mutual versus stock life insurance companies. Studies on health insurance and savings and loan associations also show stock companies as generally more efficient than mutuals.

[17]D. Mayers and C. Smith, "Ownership Structure and Control: The Mutualization of Stock Life Insurance Companies," Journal of Financial Economics, vol. 16 (1986).

Because a mutual life insurance company does not know what its taxes for a given tax year will be until well into the next tax year, it faces a degree of uncertainty. Its planning for the future becomes subject to additional uncertainty since the size of its surplus, which affects its ability to write additional insurance, is not known until its taxes are known.

The mechanism currently embodied in section 809 does not deal with the degree of uncertainty as well as alternative mechanisms could. While there is bound to be some uncertainty in any system that relies upon information that is not known to the companies at the time they are calculating their taxes, the amounts do not have to be as large as they have been. A set of alternatives that can reduce these fluctuations is discussed in chapter 3.

## Using a Stock Earnings Rate as a Basis for the Imputed Rate Raises Questions

As stated in chapter 1, section 809 calculates the average rate of return that mutual companies are distributing as earnings to policyholders as the difference between the average rates of return earned by stock and mutual companies.[14] Thus, an important premise underlying section 809 is that the relevant standard of performance for the average mutual life insurance company is that achieved by the average stock life insurance company.

However, using stock segment earnings rates as a basis for calculating the imputed earnings rate of the mutual segment raises two questions. The first is whether it is reasonable to expect a mutual company to earn as high a rate of return as a stock company. The second is what happens if there is not a close relationship or strong positive correlation between the rates of return earned by stock and mutual companies. Under plausible circumstances, fluctuations in the stock earnings rate could affect the taxes of the mutual segment in ways that undermine the usual principles of income taxation. The particular principle we have in mind is that a company's taxes should be related to that company's income, and that a company's taxes should not go up when its income goes down, or vice versa.

[14]The stock earnings rate is not used directly, but it is proportionally related to the imputed rate.

However, the Joint Committee on Taxation did not point out that a larger firm is going to be paying out more dollars in dividends than a smaller firm, so the relevant comparison is the effect of a percentage increase in dividends by a larger firm versus a similar increase by a smaller firm. Of equal importance is the fact that the larger firm will be doing greater harm to its competitors than a smaller firm, if both reduce their earnings rate by the same amount, because of its influence on the average mutual earnings rate. The Joint Committee report discussed only the per-dollar cost of larger mutuals paying more dividends, whereas the proportional "benefit," imposing more taxes on fellow mutuals, is also larger for the larger companies, for a given change in the firm's earnings rate. The above discussion is not meant to suggest that large mutuals are actually engaging in this sort of strategic behavior, only that the formula used in section 809 allows for the possibility.

## Potential Harm Does Not Depend on Changes in Behavior

The weighted average can have a detrimental effect even if there is no strong incentive for large companies to pay out more dividends to policyholders as a result of section 809. While large companies may not be actively using the formula to the disadvantage of the rest of the segment, their normal activities could lead to results similar to those described above.

More specifically, if large companies pay out above-average policyholder dividends and, as a result, their earnings rates after dividends are lower than they would have been, the differential earnings rate is higher than it would have been in the absence of this behavior. If an unweighted average were used in calculating the average mutual earnings rate, the effect on the differential rate would be minimal. With a weighted average, however, the effect on the differential earnings rate and on the taxes of other mutuals can be substantial.

Table 2.5 provides evidence that the larger companies generally pay higher-than-average policyholder dividends. As of the end of 1986, the largest 5 mutuals accounted for over 55 percent of the equity of the 120 companies in the mutual segment, while the largest 10 accounted for 72 percent of the equity. In every year but 1987, the largest 5 and 10 companies had higher-than-average dividend payout ratios. Except for 1986 and 1987, the largest 5 had higher payout ratios than the largest 10.

ratios in 1980 through 1986 than smaller companies, and the effect is the same.[11]

Income taxes are usually set up so that a company's taxes go up when its income rises and go down when its income falls. Under section 809, even if it had no change in its own income, a company could be charged with higher taxes when the average mutual earnings rate falls. This rate falls if another mutual increases its payout of dividends.

Table 2.4 shows how a large firm lowering its own earnings affects the taxable earnings of the rest of the mutual segment.

**Table 2.4: Large Mutual's Influence on Other Mutuals' Taxable Earnings**

Dollars in Millions

| Before additional $100M in dividends | Maxi Mutual | | Other mutuals | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| Equity | $8,000 | | $32,000 | |
| Earnings (retained) | 640 | | 2,560 | |
| Earnings rate | | 8.00 | | 8.00 |
| Average mutual earnings rate[a] | | 8.00 | | 8.00 |
| Differential earnings rate | | 8.50 | | 8.50 |
| Differential earnings | 680 | | 2,720 | |
| Taxable earnings | 1,320 | | 5,280 | |
| **After additional $100M in dividends** | | | | |
| Equity | 7,950[b] | | 32,000 | |
| Earnings (retained) | 540 | | 2,560 | |
| Earnings rate | | 6.79 | | 8.00 |
| Average mutual earnings rate[a] | | 7.76 | | 7.76 |
| Differential earnings rate | | 8.74 | | 8.74 |
| Differential earnings | 695 | | 2,797 | |
| Taxable earnings | 1,235 | | 5,357 | |

[a]The weighted average mutual earnings rate is the sum of all mutual earnings divided by the sum of all mutual equity.

[b]Equity falls by $50 million because it is average equity for the year. End of year equity has gone down by $100 million, but beginning of year equity is unchanged.

In the table, Maxi Mutual is a hypothetical company that holds 20 percent, or $8 billion, of the segment's $40 billion in equity. The company

[11]The dividend payout ratio is the ratio of policyholder dividends to net gain from operations before deducting dividends and taxes.

These relationships among companies with different earnings rates will result from any imputation scheme that uses averages to compute a differential earnings rate. This is commonly known as the "socialization" effect since the differential rate attributed to each company is based on average performance rather than on each company's performance.

The problem of regressivity company by company would be lessened somewhat if companies were as likely to be in the high earnings as in the low earnings group from one year to the next. However, when we examined the rankings of companies by earnings rates, we found that they changed very little over our sample period. Thus, companies ranked high on the earnings scale were very likely to remain at the high end in subsequent years. The result is that, for the years we examined, many of the same firms were consistently "undertaxed" or "overtaxed" by section 809.

## Section 809 Taxes the Mutuals More in Low- Than in High-Earnings Years

Table 2.3 also illustrates another aspect of regressivity. If the ratios of differential earnings to gross earnings or to policyholder dividends for the 2 years are compared, the ratio is higher for 1986 than it is for 1985 whether the companies were in the high or low gross earnings group. This is because, for a given average stock earnings rate and corresponding imputed rate, a higher average mutual earnings rate (measured after subtracting policyholder dividends) implies a lower differential earnings rate, and vice versa. For example, in 1986 the average mutual earnings rate was 18 percent and the differential earnings rate was zero, while in 1984 the average mutual earnings rate was 5.7 percent and the differential rate was 10.8 percent. The implication drawn by section 809 is that if mutuals have high earnings rates (after dividends), they are paying a lower proportion of dividends as earnings, and if they have low earnings rates, they are paying a higher proportion of dividends as earnings.

Evidence from the period 1984 through 1987 indicates, however, that high mutual earnings rates after subtracting policyholder dividends occurred in years when mutual earnings rates before subtracting dividends were high, and vice versa.[10] Thus, a lower than average mutual earnings rate, calculated after subtracting policyholder dividends, is not necessarily an indication that more earnings are being distributed and a higher than average earnings rate need not indicate that fewer earnings

[10]These measures of earnings are calculated without regard for realized capital gains. In 1986, measures of earnings that included realized capital gains were very high; however, measures of earnings that ignored realized capital gains were very low. For an explanation of why realized capital gains were excluded from these calculations, see appendix II.

will be a larger proportion of taxes for the companies with lower earnings rates than it will be for companies with higher earnings rates. Thus, the differential tax is regressive in that it taxes companies with weaker earnings more heavily than companies with stronger earnings. To the extent that section 809 is attempting to tax a mutual company on the basis of its own income, it may not be achieving its purpose.

To investigate this issue, we divided our sample of 28 mutual firms into two halves, using various measures of earnings as a basis for ranking firms and splitting the sample. Table 2.3 shows the results when companies are ranked by gross earnings rates.[5]

**Table 2.3: Measures of Average Earnings and Average Tax Burden for Mutuals With High Versus Low Gross Earnings Rates**

| Measure | High 14 | Low 14 | All |
|---|---|---|---|
| **1985** | | | |
| Gross earnings rate[a] | 42.91% | 20.27% | 35.51% |
| Net earnings rate[b] | 8.58 | 0.42 | 5.91 |
| Differential earnings[c] gross earnings | 21.50 | 45.52 | 25.98 |
| Differential earnings[c] policyholder dividends | 26.87 | 46.47 | 31.17 |
| **1986** | | | |
| Gross earnings rate[a] | 34.39 | 15.49 | 28.62 |
| Net earnings rate[b] | 4.90 | −0.89 | 3.14 |
| Differential earnings[c] gross earnings | 39.56 | 87.84 | 47.53 |
| Differential earnings[c] policyholder dividends | 46.14 | 83.07 | 53.38 |

[a]Net gains before payment of dividends divided by average equity.

[b]Net gains after payment of dividends divided by average equity.

[c]Differential earnings are calculated under the assumption that no capital gains were realized. For explanation, see appendix II.

We chose gross earnings rates as the basis for our ranking because they reflect earnings performance independent of company decisions to pay out dividends or realize capital gains. If the ranking had been by earnings rates after payment of policyholder dividends, called net earnings rates, the results would have been broadly similar to those in table 2.3.[6] However, the results are not as clear-cut because companies can have low earnings rates after dividends for two distinct reasons: they may be performing poorly, or they may be performing well and paying out above average dividends to policyholders.

[5]The gross earnings rate is net gains from operations before deducting policyholder dividends divided by average equity. It does not include realized capital gains.

[6]The net earnings rate is net gains from operations after deducting policyholder dividends divided by average equity.

For each year, a calculated portion of policyholder dividends is included in income for tax purposes. The amount that we use in each year from 1984 through 1987 is an estimate of the amount of differential earnings for that year. This amount results from multiplying the actual differential earnings rate by an estimate of the mutual segment's equity for that year.[3]

In calculating income, we attribute recomputed differential earnings to the year in which the earnings occurred rather than the year in which the taxes were paid or refunded. For this reason and for reasons that relate to the mechanics of section 809, the segment balance of income and taxes may not be parallel year by year, but for the 4-year period these fluctuations should even out. Table 2.2 shows that the segment balance of taxes for 1984 through 1987 closely parallels the segment balance of income, when that income is defined, as it is by section 809, to include realized capital gains.

**Table 2.2: Income[a] and Taxes by Segment, 1984-87**

| | Stocks | | Mutuals | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| Income | 34,607 | 57 | 25,761 | 43 |
| Taxes | 7,419 | 55 | 5,981 | 45 |

[a]Includes realized capital gains and mutual differential earnings.

In the past, alternative measures of segment balance such as relative shares of assets and amounts of insurance issued or in force have been employed as indicators of whether the segment balance of taxes was being achieved. None of these measures indicates what the proper allocation of taxes should be, since none is a measure of income and the tax is an income tax. Thus, correctly defining taxable income and then examining whether taxes split in accord with that income is a better way of determining if segment balance is achieved than applying some arbitrarily determined tax split. In addition, there should be no expectation that the mutual-stock tax split that exists in one year will necessarily carry over to another year, since income can fluctuate from year to year.

As we have seen, under various assumptions, the tax and income split varied between 1984 and 1987. Although the 55-45 mutual-stock tax split was never achieved, the mutual-stock taxes that were incurred

[3]For a discussion of the reasons for estimating equity and the method used for that estimation, see appendix II.

The mechanics of section 809 also give rise to potential problems. Using an average mutual earnings rate that is weighted by company equity causes large mutuals, who pay out greater-than-average policyholder dividends, to significantly reduce the average mutual earnings rate and raise the differential earnings rate for everyone. Also, the method of recomputation embedded in section 809 leads to exaggerated recomputations from one year to the next, thereby increasing a company's uncertainty about tax liabilities.

In addition, a more fundamental question about section 809 is the appropriateness of using the stock company as a model for the mutual company, and in particular using the earnings rate of stock life insurance companies as a measure of mutual company performance.

## The Mutual-Stock Segment Balance of Taxes Is Consistent With Measures of the Mutual-Stock Income Split

The segment balance of taxes is a measure of the relative proportions of the life insurance industry tax bill paid by mutual and stock companies. Since the tax is an income tax, it should follow that the mutual-stock payment of taxes ought to be in about the same proportion as the mutual-stock division of income. Defining mutual income, however, is the problem.

To overcome this problem and estimate the mutuals' income, we applied very broad and very narrow definitions of income to establish upper and lower bounds for the mutual-stock income split. In addition, we constructed a measure of income that is based on the section 809 method.[2] We believe that a tax split substantially different from this income split would provide prima facie evidence that a problem exists either with the way section 809 was set up or with the way it is being implemented. It will not tell us if section 809, itself, properly measures income.

Certain measures of income exist that allow us to define the upper and lower boundaries for the segment balance of income. There is a segment balance of taxes for each measure of income. Table 2.1 shows for 1984 through 1987 two standard measures of life insurance company income: (1) net gains from operations before policyholder dividends and taxes plus realized capital gains and (2) net gains after policyholder dividends but before taxes plus realized capital gains. The first of these is a measure of gross income, which treats as income the premium rebate (or

[2]Our approach uses the section 809 method to measure mutual company income. The remaining sections of this chapter and the subsequent chapter will raise questions about whether this is the best way to measure income. A similar measure of the mutual-stock split can be constructed by using any of the alternatives suggested in chapter 3.

On the issue of consolidation, we believe that the best measure of the tax burden of the life insurance industry is taxes incurred by life insurance companies. For the purposes of this analysis, we did not consider non-life affiliates with potential losses to offset taxable income and reduce overall taxes.

insurance industry and individual companies to see if these taxes were in accord with a proportional or progressive tax on company income and to suggest some adjustments to the procedure if warranted. Our third objective was that, if we noted basic difficulties with the section 809 procedure, such as regressivity, we were to identify and examine the effects of alternative approaches to the issue of defining taxable income for mutual life companies.

To accomplish these objectives, we used various sources of information. For our analysis of the amount of income earned by the stock and mutual life companies and its relationship to taxes, we used net gains from operations before and after deduction of policyholder dividends, as well as measures of the part of earnings distributed in the form of policyholder dividends. Net gains from operations before and after dividends came from the work we did in preparing the fact sheet. We gathered information from Best's Insurance Reports, Life-Health and Best's Aggregates and Averages, Life-Health. We obtained measures of distributed earnings from examining the effect of section 809. In calculating the amount of differential earnings, we used information from the period 1984-1987, for which we have financial statement information.

For our analyses of the overall effects of section 809 on the stock and mutual segments and of the alternative approaches, we used measures of the relevant earnings rates, released by Treasury, for the years 1984 through 1987. We also used the industry and segmentwide information on net gains from operations, policyholder dividends, and realized capital gains that we had compiled for our fact sheet.

Analyzing the effects of section 809 on different types of mutual firms and analyzing the implications of changing the formula in section 809 required that we examine data on individual firms. To do this, we gathered publicly available financial data for 1985 and 1986 from the Insurance Administration, Washington D.C. Department of Consumer and Regulatory Affairs, on the 50 largest stock life insurance companies and their life insurance subsidiaries and affiliates and on the 28 largest mutual life insurance companies and their life insurance subsidiaries. We chose the 50 largest stock companies because section 809 specifies that the average stock earnings rate be an average of the largest 50 firms in the stock segment. We chose the largest 28 mutuals because these firms encompass about 92 percent of the assets in the segment as well as a mix of companies from very large to small. We also used this financial data to estimate the average equity for the mutual segment for

## Taxes Incurred by the Mutual and Stock Segments of the Life Insurance Industry

On February 11, 1987, the Chairman of the Subcommittee on Select Revenue Measures, and the Chairman of the Subcommittee on Health of the House Committee on Ways and Means asked us to provide data on the stock and mutual segments of the life insurance industry for the years 1984, 1985, and 1986. In addition, they requested that we evaluate how the law might need restructuring if the data warranted adjusting the segment balance.

In response to the request for data on the life insurance industry, we issued a fact sheet entitled Tax Policy: Information on the Stock and Mutual Segments of the Life Insurance Industry (GAO/GGD-88-88FS, Sept. 26, 1988). The Department of the Treasury has also issued an Interim Report to the Congress on Life Insurance Company Taxation and a Final Report to Congress on Life Insurance Company Taxation. Our fact sheet is based on data from 1984, 1985, and 1986 insurance company financial statements, and the Treasury reports include financial statement data as well as tax return data compiled from a survey Treasury conducted for 1984 and 1985 and a sample of tax returns for 1986.

Table 1.1 summarizes relevant information from our report and the Treasury reports, as well as similar information for 1987. For 1984, the estimated $3 billion in industry tax revenue was narrowly missed, but the segment split of 55 percent mutual-45 percent stock was not attained. This is true whether one looks at tax return data or financial statement data. In 1985 and 1986, total taxes did rise above the JCT revenue estimates—which were $3.1 billion for 1985 and $3.4 billion for 1986—at least before consolidation. To some extent for 1985, but especially for 1986, the estimates were exceeded due to substantial capital gains realizations. The 1987 taxes fell considerably short of the estimated revenues, even before consolidation. The 55-45 mutual-stock split expected by Congress was not achieved in any of the 4 years.

In its report, Treasury states that the revenue estimates were done on a consolidated basis. We used financial statements and were unable to calculate taxes on such a basis. However, we believe that taxes before consolidation give a better measure of the tax burden of the life insurance industry than taxes after consolidation, because the latter includes income or losses from outside of the industry.

## Section 809 Attempts to Measure Mutual Company Taxable Income

The return on the equity portion of policyholder dividends is not directly observable. As a result, section 809 of the Internal Revenue Code prescribes a form of imputation to calculate the return indirectly. Imputation means attributing the value of an observable variable to a variable that is not observable.

Section 809 prescribes a method for imputing a return on equity and, thus, for calculating the part of policyholder dividends that represents a distribution of earnings to the policyholder. The details of this method are explained in appendix I. This chapter gives an overview of what section 809 attempts to accomplish.

In deciding on a method for computing the taxable income of mutual companies, Congress noted that their average return on equity—after dividends but before taxes—fell below the return for a comparable group of stock companies. It believed that this difference was attributable to the distribution of earnings by mutual companies to their owners, that is, to policyholders.[3] Therefore, Congress enacted section 809, which prescribes a formula for adjusting the average earnings rate of the stock segment to calculate an imputed earnings rate for the mutual segment. The average stock earnings rate and the imputed rate are not the same but they move together in a manner described more fully in appendix I. The legislation set the imputed rate for 1984 at 16.5 percent. Congress expected that this rate would result in the mutual segment paying 55 percent and the stock segment 45 percent of a $3 billion life insurance tax bill.

The imputed rate is a measure of the return on equity that is assumed to have been earned by each mutual company. It includes the part of earnings that is undistributed (increases in surplus) as well as what might be termed the stockholder dividend equivalent, which section 809 is attempting to measure.

To measure the part of earnings presumed to be distributed in the form of policyholder dividends, section 809 first outlines a procedure for calculating the "differential earnings rate." This rate is the difference between the imputed rate and the average mutual earnings rate. The average mutual earnings rate is the sum of the earnings (after deducting policyholder dividends) of all mutual life insurance companies divided by the sum of the average equity bases for the mutual segment (the

[3]General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the staff of the Joint Committee on Taxation (Dec. 31, 1984), p. 612.

# Introduction

Within the life insurance industry are two types of companies: stock and mutual. The stock segment has over 2,100 companies, and the mutual segment has over 120. The primary difference between the two organizational forms is ownership. Policyholders, who are customers, own the mutual companies; shareholders, who may or may not be customers, own the stock companies.

Defining income for tax purposes for both the stock and mutual segments has changed over time as the structure of the industry, the economic environment, and tax revenue needs have evolved. Under the Life Insurance Company Income Tax Act of 1959 (Public Law 86-69), a complicated computation of investment and underwriting income served as the basis for taxing life insurance income.[1]

The 1959 act governed taxation of the industry until it was superseded, first by the stopgap provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) and then by the Deficit Reduction Act of 1984 (Public Law 98-369), which caused more fundamental changes to the Internal Revenue Code. That act, among other things, taxed life insurance companies in a manner that more closely resembled the taxation of other corporations. The act prescribed a method of measuring taxable income for the mutual segment and, for 1984 only, legislated earnings rates or ratios of income to equity. The Joint Committee on Taxation (JCT) estimated that, after the new law, the life insurance industry would pay $3 billion in federal taxes in 1984, with 55 percent of the taxes coming from the mutual segment and 45 percent from the stock segment.

## Defining Taxable Income for Stock and Mutual Companies

One purpose of the life insurance company provisions of the Deficit Reduction Act of 1984 was to make the taxation of these companies more closely resemble the taxation of other corporations. In this regard, the taxation of stock life insurance companies was not conceptually difficult. Like other corporations, stock companies may retain their income as undistributed earnings, may distribute income to stockholders in the form of dividends, or may do both. Regardless of whether they distribute their income or not, all of it remains in their corporate tax base.

[1]The details of this act are discussed in our report entitled Billions of Dollars Are Involved in Taxation of the Life Insurance Industry—Some Corrections in the Law Are Needed (PAD-81-1, Sept. 17, 1981).

# Contents

weighted by company equity. If a big mutual reduces its earnings rate (after dividends), the effect on the average mutual earnings rate would be larger than if a smaller company did the same. This raises the differential earnings rate substantially, as well as section 809 taxes on all mutuals. (See pp. 25-29.)

## Alternatives to Section 809

GAO examined a number of alternative methods for determining a mutual life insurance company's taxable income and believes the most equitable one is to delete section 809 from the tax code and allow mutual life insurance companies to deduct all policyholder dividends in determining corporate taxable income. This alternative is consistent with the "prepayment" approach which holds that mutuals have already paid a tax on the earnings distributed as dividends since the excess premiums that were the source of those earnings, and that were part of the policy's purchase price, were initially included in company income. (See pp. 40-45.)

GAO's alternative would tax policyholders on the earnings part of dividends received from mutual companies, and also in those instances where stock companies pay dividends to policyholders on certain types of policies. Under this proposal, the tax burden of the mutual segment would be reduced, while those stock companies that pay policyholder dividends would face a tax increase since these dividends are currently fully deductible. GAO believes, however, that taxing earnings paid to all policyholders will go a long way toward equalizing the tax treatment of policyholders with that of stockholders.

The most efficient method to tax these earnings is for Congress to designate a percentage of policyholder dividends as taxable income. This percentage would be based on the dividend payout behavior of shareholder-owned corporations and would provide a more accurate measurement of dividend distribution behavior than the current method, as well as being more equitable company by company and year by year. GAO's calculations indicate that a proportion of policyholder dividends equivalent to 6 percent of equity would properly reflect annual dividend payouts in the 1980s. (See pp. 51-62.)

Stocks and mutuals could be required to notify each policyholder of the amount of attributed earnings. The policyholder would then include that amount in taxable income. Alternatively, since the earnings amount is an average, GAO believes that stock and mutual companies should apply an average tax rate, determined by Congress, and pay the tax as a proxy

# Executive Summary

## Purpose

The life insurance industry incurred more than $13 billion in federal income taxes from 1984 through 1987—45 percent by mutual life insurance companies and 55 percent by stock life insurance companies. A matter of recent debate within the industry is whether the mutual companies are paying their fair share.

Congress enacted section 809 of the Internal Revenue Code to make the definition of mutual company income more closely parallel that of stock company income. The chairmen of two subcommittees of the House Ways and Means Committee asked GAO to assess how this provision has affected the income tax split between the stock and mutual segments of the industry and within the mutual segment itself. They also asked GAO to examine alternative methods of taxing mutual life insurance companies.

## Background

A stock life insurance company is owned by its stockholders and distributes earnings to these owners by paying dividends. These dividends are subject to income tax at both the company and the individual stockholder level. Mutual life insurance companies, however, are owned by their policyholders. Consequently, it cannot be precisely determined what portion of the dividends paid to policyholders is a distribution of the company's earnings, and therefore taxable, and what is simply a refund of excess premiums, which is not taxable.

Section 809 attempts to isolate the earnings component of mutuals' policyholder dividends so that mutual companies pay taxes on earnings distributions as stock companies do. It also attempts to compensate for the absence of full individual taxation on dividends paid by mutuals. The way section 809 tries to isolate these earnings is by calculating an imputed earnings rate for the mutual companies based on the average earnings rate of stock life insurance companies. The imputed rate represents the return on equity that is assumed to have been earned by the average mutual company and is used, in turn, to calculate a differential earnings rate for all mutuals. All of these calculations are done by the Treasury, which makes the resulting rates public. Each mutual company multiplies the differential earnings rate by its average equity to estimate how much of the dividends paid to its policyholders is a distribution of earnings. The company then adds the resulting dollar amount to its taxable income.