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Taxes Incurred by, and Business Trends of, the Life Insurance Industry

Statement of
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Subcommittee on Select Revenue Measures
Committee on Ways and Means
House of Representatives

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TAXES INCURRED BY, AND BUSINESS TRENDS OF, THE LIFE INSURANCE INDUSTRY

SUMMARY OF STATEMENT BY
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The Deficit Reduction Act of 1984 changed the way that life insurance companies are taxed. The act tries to tax life insurance companies in a way that parallels other companies. Defining income for stock life insurance companies is not very difficult, but mutual companies present a special problem. The problem is to measure the part of policyholder dividends that represents a payout of earnings by a mutual company versus the part that represents a refund of excess premiums paid by the policyholder. Section 809 of the Internal Revenue Code imposes a method for reducing the amount of policyholder dividends that mutual life insurance companies are allowed to deduct.

For the period 1984 through 1986, as a whole, taxes incurred by the life insurance industry were somewhat greater than expected. In 1984 taxes incurred were $2.8 billion, while the revenue estimate was $3 billion. For 1985 and 1986 taxes incurred exceeded the revenue estimates by $1.0 and $1.3 billion. Much of this was due to large capital gains realizations, especially in 1986. The mutual segment paid less than the 55 percent of industry taxes that was estimated in 1984, but not necessarily less than the proportion that mutual company income represented of industry income.

The mutual share of many important industry variables, such as assets and capital and surplus, declined from 1984 through 1986. However, the mutual share of insurance in force, premium income, and new insurance issued increased slightly during the period.

We are continuing a study of section 809 to see whether it has achieved the goal of equitably allocating taxes between the segments (segment balance) and among firms within the mutual segment. Our analysis focuses on certain issues, such as the allocation of taxes on a company-by-company basis, that arise regarding section 809. We are also examining alternatives to the segment balance mechanism, such as using an imputed rate from outside the life insurance industry or designating a proportion of policyholder dividends to be included in taxable income.

Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to help in your hearing on the amount of taxes paid by the life insurance industry and how these taxes are allocated within the industry.

Mr. Chairman, you and the Chairman of the Subcommittee on Health of the House Committee on Ways and Means asked us to gather data on the taxes paid by, and business trends of, life insurance companies for 1984, 1985 and 1986. Yesterday we issued a report addressing your request.

You also asked us to evaluate the segment balance mechanism in section 809 of the Internal Revenue Code, which tries to maintain a specific distribution of the life insurance industry tax burden between the stock and mutual segments of the industry. We are now completing that evaluation in which we are exploring questions raised by the existing mechanism and examining alternative approaches to segment balance that have been suggested.

Before I discuss the industry data in our report and our ongoing analysis of section 809, I would like to provide some background on life insurance taxation.

TAX LAWS AND THEIR EFFECTS ON THE STOCK-MUTUAL COMPANY BALANCE

For over two decades the legislation that controlled the taxation of life insurance companies was contained in the Life Insurance Company Income Tax Act of 1959. This act was oriented to the industry as it was then structured. Some of the industry's important characteristics included: (1) the dominance of the mutual segment as measured by items such as insurance in force and assets, (2) the importance of whole life policies which generated large reserves and investment income, and (3) a moderate rate of inflation, compared to much higher rates in the 1970s and early 1980s. In addition, the law made special provision for the long-term nature of the life insurance business and attempted to foster the survival of small life insurance companies.

After passage of the 1959 act, changing economic conditions--particularly higher interest rates--raised doubts about the appropriateness of certain of the act's provisions. Many insurance companies used various provisions in the law, especially distinctions between types of income, to reduce their taxes. In addition, the balance of the industry between stock and mutual companies was changing, and mutuals no longer dominated all areas. The lines of insurance written by companies shifted from whole life to an increasing reliance on term and group insurance. As a result, Congress saw a need to change the tax treatment of life insurance.

The Deficit Reduction Act of 1984 changed the way that life insurance companies were taxed. The most important change was to do away with the distinction between investment income and underwriting income embedded in the 1959 act. The intent of the 1984 act is to tax life insurance companies in a way that parallels the taxation of other companies. This means taxing all gains from operations without distinguishing between sources of income.

Mutual companies are still a very important part of the industry, and the problem arose as to how they should be treated under the new law. The income of stock companies consists of dividends that are paid to shareholders and earnings that are retained by the company. Mutual companies also add retained earnings to their surplus, and this addition is classified as taxable income. However, the dividends they pay to their policyholders, who are the owners of the mutual companies, are not so easily categorized. The difficulty is disentangling the part of policyholder dividends that is income to the mutuals (a return on equity) from the other elements which are not income (a return of excess premiums).

Section 809 of the Internal Revenue Code imposes a method for reducing the amount of policyholder dividends that mutual life insurance companies are allowed to deduct. In effect, a return on equity is imputed to the mutual segment of the industry based on the performance of the stock segment. Based on this imputed rate and the average earnings rate of the mutual segment, each mutual company must include in taxable income an amount that represents the part of policyholder dividends that is paid out as earnings. The intended effect is to treat the policyholders of mutual companies as if they are shareholders for corporate tax purposes.

INDUSTRY DATA

In brief, our analysis shows that the total taxes incurred by the industry over the three year period (1984-1986) exceeded the revenue estimates made by the Joint Committee on Taxation before the 1984 act was passed. However, our analysis also shows that the taxes incurred did not split into the ratio Congress had envisioned--55 percent for mutual companies and 45 percent for stock companies.

In 1984 the life insurance industry incurred $2.8 billion in taxes, slightly less than the $3.0 billion revenue estimate. However, the 1985 and 1986 taxes incurred were $1.0 and $1.3 billion greater than the respective revenue estimates. This was largely attributable to high capital gains income in those years resulting from a favorable stock market performance in the mid-1980s, followed by large sell-offs of securities preceding the 1987 increase in the corporate capital gains tax rate.

The segment balance, however, did not split as expected. In fact, in 1984 the balance was virtually reversed from that expected, with stock companies incurring 56 percent of the taxes and the mutual segment accounting for 44 percent. In 1985, the mutual segment accounted for 49 percent and, in 1986, for 51 percent.

The Treasury Department has also studied the effect of the Deficit Reduction Act of 1984 on the taxes paid by mutual and stock companies. Treasury acquired its data by asking the companies what amount of taxes they paid. Our data came from financial statements filed with state regulators, as reported by A.M. Best. Thus, our figures may differ from Treasury's. Regardless, both studies tell the same story--the mutual segment of the industry did not pay as high a proportion of taxes as Congress envisioned when the bill was enacted.

In addition, preliminary data indicates that the taxes of the mutual segment will likely decrease for 1987. We base this observation on the following. First, data obtained for a sample of the largest 28 mutual companies, which held roughly 90 percent of the mutual segment's assets, indicates that operating income for 1987 was comparable to that for 1986 and that capital gains income was substantially less than for 1986. Second, Treasury's recently announced differential earnings rate--to be applied in making the initial 1987 computation under section 809--is the lowest for the four-year period. As a result, it will logically produce low earnings and taxes from the section 809 computation. Third, due to the difference between the estimated and actual earnings rate, the recomputation of 1986 taxes--to be reflected on 1987 returns-- will result in a large refund--close to $1.5 billion. Thus, while the available data is not sufficient to precisely calculate the taxes for 1987, it points directly to lower taxes for the mutual segment.

Similarly, in the 1984-1986 period, the mutual segment's portion of taxes on income from operations was less than expected because its share of income from operations was lower. This income, before deducting policyholder dividends or taxes, fell from 57 percent of industry income in 1984 to 52 percent of industry income in 1986. Measured after policyholder dividends but before taxes, mutuals' income declined from 32 percent of the industry total in 1984 to 17 percent in 1986.

Whether this weakening in the income position of the mutual segment represents a long-term trend or whether it is simply an aberration is difficult to judge over such a short period. However, in many other categories the movement for the mutual segment was downward as well. For instance, the mutual proportion of total industry assets, capital and surplus, and investment income all moved downward from 1984 through 1986.

In contrast, insurance in force and premium income, a level proportion during 1984 and 1985, rose slightly in 1986. New insurance issued rose slightly as a proportion of the totals for the industry in each year. Even with this improvement, the mutual segment only wrote about 38 percent of the new insurance in the industry in 1986.

During 1984 through 1986, the composition of asset portfolios changed very little. Bonds continued to be the largest component of assets for stocks and mutuals, though they were more important for stocks. Mutual companies held a slightly higher proportion of their assets in the form of mortgage loans and real estate than did stock companies. Policy loans continued to be more important for mutual than for stock companies though they were not a large part of either segment's assets. For each of the three years, the yield on admitted assets--those permitted by state regulators in determining a company's financial condition--was lower for mutuals than for stocks.

EVALUATION OF SECTION 809

We are also evaluating how well the segment balance mechanism works. Although we have not yet reached final conclusions, our preliminary analysis has led us to some tentative observations.

The industry data indicate that if segment balance is evaluated in terms of a 55/45 mutual-stock breakdown, segment balance was not achieved over the 1984 through 1986 period. If, however, segment balance is evaluated by whether the mutual-stock breakdown of taxes is consistent with the mutual-stock breakdown of income, the conclusion might be different. For the period 1984 through 1986, the segment balance of taxes appeared consistent with the segment balance of income as computed using section 809.

Regardless of the breakdown of taxes between stocks and mutuals, there are still potential problems with the section 809 method. Among the issues that we are studying is whether the section 809 mechanism leads to inequities for the mutual segment on a year-to-year basis. The additional tax imposed by section 809 is based on the difference between the imputed rate of return and the average mutual rate of return on equity. As a result, in years when the mutual segment's earnings rate is below its historical average, the section 809 mechanism will have the firms in the segment add a larger amount to their taxable income than in years when the mutual performance is above average. The mutuals are taxed as if they are paying out more earnings to their policyholders when they perform poorly than when they perform well.

Another issue is whether the mechanism imposes a regressive tax burden on a company-by-company basis. In other words, do mutual companies with lower earnings pay a higher proportion of their income in the form of the extra tax imposed by section 809? Because section 809 uses averages in its computations, companies pay taxes on the basis of what the average stock and the average mutual company earn. Thus, companies with below average earnings may be "overtaxed" and companies with above average earnings "undertaxed".

A third issue relates to the use of an average mutual earnings rate in which the average is weighted by company equity. If the larger mutuals pay out above average policyholder dividends, the weighted average earnings rate will be pushed down substantially. The result is that the average "extra" tax imposed by section 809 will be higher for all the firms in the segment. The decisions of one set of firms--in this case the larger mutuals--affect the taxes paid by another set--in this case all the other mutuals.

Another potential problem with section 809 involves using the stock company as a model for taxing mutual companies. If mutual companies are not as cost-conscious as stock companies, or if mutuals are more averse to risk-taking, on average they will earn lower returns on equity than stock companies. In this case, imputing taxable income to mutuals on the basis of stock company performance would result in overtaxing the entire mutual segment.

In addition to examining issues regarding section 809, we are also analyzing a range of alternatives to the 809 procedure.

-- Under one suggested alternative, mutual firms would not be taxed on any part of policyholder dividends because they are presumed to have prepaid the tax due on those dividends when the excess premium was initially included in underwriting income.

-- Another approach would use a different basis for imputation than the stock segment's return on equity. It would use the return on an alternative asset, such as a tax-free bond, as the basis for imputation.

-- A third alternative would exclude a stated proportion of policyholder dividends from the allowable deduction.

SUMMARY

In sum, our report indicates that the taxes incurred by the industry did not split in the expected ratio. In general, the mutual segment incurred a smaller proportion of taxes than had been expected in 1984. But the proportion of each segment's taxes was consistent with the proportion of each segment's income. Currently we are evaluating the section 809 mechanism as well as alternatives to that mechanism. We hope to report to you on our results next year.

This concludes my prepared statement. We would be pleased to respond to any questions.