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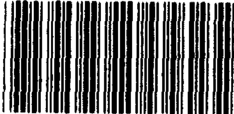

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STATEMENT OF

ARTHUR J. CORAZZINI

DEPUTY DIRECTOR, PROGRAM ANALYSIS DIVISION

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES OF

THE HOUSE WAYS AND MEANS COMMITTEE

ON

TAXATION OF THE U. S. LIFE INSURANCE INDUSTRY

Mr. Chairman and Members of the Committee:

We are pleased to be here today to give you our views on some facets of taxation of the life insurance industry. Our 1981 report on this subject recommended some specific changes in the Life Insurance Company Income Tax Act of 1959, which we found to be seriously in need of revision. Since then, changes in the tax treatment of the industry were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, but many of the provisions included in the stopgap legislation will expire at the end of this year. We hope that our comments today will contribute to your important task of arriving at suitable permanent tax legislation for the industry.

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Since the passage of the 1959 Act, changing economic conditions--most notably inflation and its effect on interest rates--have raised doubts about the appropriateness of certain provisions of the Act. The insurance companies used various provisions in the law to reduce what they believed to be unduly burdensome taxes. Most notable among the avenues of relief found was the increasing use of modified coinsurance arrangements under Section 820 of the Internal Revenue Code.

The stopgap provisions of TEFRA included the repeal of Section 820. Taxes paid under the new provisions are higher than what would have been paid if modified coinsurance were allowed to continue. However, tax revenues under the stopgap provisions are much lower than they would have been under the provisions of the 1959 Act, before the widespread use of modified coinsurance. For this reason, as well as the imminent expiration of the stopgap provisions, a reexamination of the issues is now needed.

The most important factor influencing the taxation of the insurance industry is the share of investment income which should be accorded tax-free treatment. As a follow-up on our earlier work, we have studied the effect of the stopgap provisions as well as other proposed methods of taxation of investment income. Our on-going analysis has been limited to the 10 largest mutual companies and the 10 largest stock companies for 1978 and 1979. While this appears to be a small sample, these companies hold more than 60 percent of the assets of the industry.

The results we have developed to date are shown in the tables accompanying my statement. I appreciate the opportunity to share them with you.

Referring to Table 1, we found that under the 1959 Act about 75 percent of investment income escaped taxation in 1978 and 1979. Modified coinsurance was not widely used in those years. Had the stopgap provisions been in effect at that time, we estimate that over 80 percent of investment income would not have been taxed. Turning to Table 2, the additional tax collected in 1978 under the 1959 Act for our sample of companies was about $534 million more than would have been collected under the 1982 stopgap provisions. For 1979, the additional taxes from the 1959 Act as compared with the 1982 stopgap were $571 million.

We have also estimated the additional taxes that would result from taxation methods other than those contained in the 1982 stopgap provisions. In our 1981 report we calculated tax liabilities of a much larger sample, the 42 largest companies, using two alternative reserve deduction methods. These methods are: (1) a policyholders' reserve deduction at an assumed rate, averaging 3 percent, and (2) a reserve deduction at 4.5 percent, the maximum assumed rate allowed in most States.

For the current sample, the 4.5 percent method would have raised $723 million more in taxes in 1978 than the 1982 stopgap provisions. This represents an increase of 61 percent. For 1979, the comparable figure is $726 million, or 80 percent more.

These results can be found in Table 3. In Table 4, we see that for 1978, if the 3 percent assumed rate had been used for the policyholders' reserve deduction, there would have been about $1.2 billion more taxes than would have been collected under the 1982 stopgap. The taxes under the assumed interest rate basis would have been almost double those under the 1982 stopgap provisions. For 1979, the taxes raised under this method would have more than doubled.

I would like, at this point, to offer some brief additional remarks on our current thinking about several other areas of the 1959 Act that deserve careful scrutiny.

The 1959 Act allows for a special deduction for group life and accident and health lines of business because of a judgment reflected in the Act that these lines of business carry more risk than ordinary life insurance. Our current analyses of 20 large companies involved in group business indicates that over the four years, 1978-81, only one company experienced a loss in the group life line.

For the accident and health line of business, the 20 companies in our sample experienced a net loss over the four-year period. But the experience was not uniform. While all but 1 of the 10 largest mutual companies showed a loss over the period, the reverse was true for the stock companies, with all but 1 company showing a gain.

Based on these results, we believe that the deduction for the group life line of business should be reconsidered.

With regard to Section 818(c), the preliminary term reserve revaluation section of the Act, note that our 1981 report recommended changes to the basis for approximate revaluation of reserves and that the 1982 stopgap provisions in part followed our recommendations. We reiterate our previous recommendation that changes need to be made in this section. With the recent proliferation of graded premium policies, our current thinking is that Section 818(c)(2) providing for approximate revaluation should be repealed, and that only exact revaluation is more appropriate.

I also want to reiterate our 1981 report recommendation that in light of changed conditions over the years, the deferral of one-half of underwriting gains currently allowed in the law should be phased out.

I have one final comment for your consideration. Conceptually we agree with proposals to unbundle insurance contracts into their investment and underwriting components for purposes of taxation. However, because of the variance from year to year in the rate assumptions used by the companies, and the very large number of different types of policies still in force, there is a question as to how dividends to policyholders can be separated into the true excess interest portion and the underwriting gain portion.

We feel this type of proposal deserves careful attention. We are willing to assist this committee in any way we can.

That concludes my prepared statement. At this time we will be happy to answer any questions you may have.

Table 1

Percentage of Investment Income Not Taxed of the 10 Largest Mutuals and 10 Largest Stocks

	Stock	Mutual	Total
1978			
Stopgap	74.9%	82.9%	80.9%
1959 Act	72.9	73.7	73.5
4.5%	71.1	70.9	71.0
Assumed Rate	67.8	63.6	64.6
1979*			
Stopgap	81.9%	85.3%	84.6%
1959 Act	78.3	74.9	75.6
4.5%	77.1	72.0	73.1
Assumed Rate	74.2	65.9	67.7

Table 2

A Comparison of Taxes in 1978 and 1979 Between the 1959 Act and 1982 Stopgap
($000,000 omitted)

	(1) 1959 Act	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
1978				
10 Mutual	$1,283.3	$ 782.8	$500.5	163.9%
10 Stock	434.6	401.1	33.5	108.4
Total	$1,717.9	$1,183.9	$534.0	145.1%
1979*				
8 Mutual	$1,230.7	$710.9	$519.8	173.1%
6 Stock	286.1	234.6	51.5	122.0
Total	$1,516.8	$945.5	$571.3	160.4%

*Figures for all 20 companies were not available for this year (8 of 10 mutual companies and 6 of 10 stock companies were available).

Table 3

A Comparison of Taxes in 1978 and 1979
Between the 4.5% Method and the 1982 Stopgap
($000,000 omitted)

	(1) 4.5% Method	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
1978				
10 Mutual	$1,438.9	$ 782.8	$656.1	183.8%
10 Stock	468.2	401.1	67.1	116.7
Total	$1,907.1	$1,183.9	$723.2	161.1%
1979*				
7 Mutual	$1,336.0	$677.8	$658.2	197.1%
6 Stock	302.2	234.6	67.6	128.8
Total	$1,638.2	$912.4	$725.8	179.5%

*Figures for all 20 companies were not available for this year (7 of 10 mutual companies and 6 of 10 stock companies were available).

Table 4

A Comparison of Taxes in 1978 and 1979
Between the Assumed Rate Method and the 1982 Stopgap
($000,000 omitted)

	(1) Assumed Rate Method	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
1978				
10 Mutual	$1,838.0	$ 782.8	$1,055.2	234.8%
10 Stock	522.5	401.1	121.4	130.3
Total	$2,360.5	$1,183.9	$1,176.6	199.4%
1979*				
7 Mutual	$1,640.2	$677.8	$ 962.4	242.0%
6 Stock	343.7	234.6	109.1	146.5
Total	$1,983.9	$912.4	$1,071.5	217.4%

*Figures for all 20 companies were not available for this year (7 of 10 mutual companies and 6 of 10 stock companies were available).