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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROGRAM ANALYSIS DIVISION

B-206899

APRIL 14, 1982

The Honorable Dan Rostenkowski
Chairman, Joint Committee on
Taxation
Congress of the United States

Dear Mr. Chairman:

Subject: Modified Coinsurance and Its Use by Some Life Insurance Companies to Reduce Taxes (PAD-82-33)

On December 23, 1981, your committee asked us to analyze the characteristics of modified coinsurance transactions and the extent of their use by life insurance companies. To conduct this analysis, we studied data on Federal income taxes incurred as well as modified coinsurance reported for the period 1978-80. Our sample consisted of 42 large life insurance companies used in our earlier study, "Billions of Dollars Are Involved In Taxation Of The Life Insurance Industry--Some Corrections In The Law Are Needed," PAD-81-1. Our analysis indicates that life insurance companies have increased their use of modified coinsurance and have reduced their tax burdens. Furthermore, we are unable to identify any factors other than the increased use of modified coinsurance that could explain the observed decrease in tax liability.

BACKGROUND

Modified coinsurance is an arrangement in which insurance companies share risk. By entering into these arrangements under section 820 of the Internal Revenue Code, some insurance companies--primarily large mutual companies--are able to convert their investment income, on which they pay tax, into underwriting income, on which they pay little if any tax. The additional underwriting income is not usually taxed because mutual companies credit it to owners/policyholders in the form of deductible dividends.

Section 820 was intended to prevent double taxation when modified coinsurance arrangements are used. Without a section 820 election, double taxation could occur because both the original insurer and the company sharing the risk would be subject to tax on some of the same income. However, section 820 was never intended to serve as a mechanism for reducing tax liabilities.

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Our sample of 42 large life insurance companies (24 mutuals and 18 stocks) held 73 percent of the industry's assets, about 60 percent of insurance in force, and collected about 54 percent of the industry's premiums. We are confident that our sample companies pay the bulk of the industry's Federal income taxes. 1/ We collected data for the sample from the annual statements filed with the various State Insurance Commissioners as well as data from A. M. Best and Company, the principal reporter of life insurance industry data. In addition, we collected selected data on the entire industry.

FINDINGS

--For the sample companies, reported modified coinsurance increased from about $7 billion in 1979 to about $147 billion in 1980. Of this increase, the 10 largest mutual companies accounted for about $112 billion, or about 80 percent.

--These companies reduced their tax burdens in 1980 from the prior year by about $625 million. The 10 largest mutual companies accounted for $558 million, or 90 percent of this reduction.

--Our estimate of the entire industry's tax burden indicates a 1980 revenue loss of approximately $1.5 billion, a drop of about 37 percent from what the companies would have paid had they not used modified coinsurance. The 1981 revenue loss estimate is about $3.4 billion, or about 74 percent.

The tables and graphs in the enclosure contain further details on the results of our analysis.

The IRS has proposed rules regarding section 820, issued March 16, 1982, that would, if made final, prevent companies from converting investment income into underwriting income to the extent now permitted. Thus, the IRS rules are intended to prevent further use of section 820 to reduce taxes.

CONCLUSIONS

Elimination of section 820 would no doubt eventually correct the current reduction of enormous amounts of Federal income taxes. However, we believe its elimination could reintroduce the problem of double taxation. Furthermore, we believe that the problem of section 820 should be viewed in the larger context of the Life

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1/The Federal income taxes incurred are reported as an integral part of the annual statement. These are estimates, not actual taxes paid. Therefore, our figures are not final tax liabilities.

Insurance Company Income Tax Act of 1959. In this regard, it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates. Inflation and the high interest rates of recent years are dramatically different from those that existed in 1959. Because of these changed conditions the 1959 Act has not operated in the manner originally envisioned.

At the request of your office, we did not obtain agency comments on this report. As requested, we will make copies of this report available to the Department of the Treasury and the Internal Revenue Service and will forward to you any comments they may have. If you have any questions about this letter, or if we can be of further assistance to you, please call us.

Sincerely yours,

Morton A. Myers

Morton A. Myers
Director

Enclosures

Table 1

Comparison of Sample with Industry 1980
($ in billions)

	U.S. Life Companies	Sample	Percent of Industry
Number of Companies	1,948	42	2%
Assets	$ 479.210	$ 349.843	73%
Insurance in Force	4,029.877	2,396.859	59
New Insurance Issued	596.738	320.220	54
Premiums	94.225	55.397	59

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

Table 2

Modified Coinsurance Reported
($ in billions)

	1979	1980	Dollar Change	Percent Change
Prudential	$ -	$ 12.860	$ 12.860	*
Metropolitan	-	39.657	39.657	*
10 largest mutuals	1.289	112.871	111.582	8,656%
24 sample mutuals	6.446	128.259	121.813	1,890
10 largest stocks	-	15.243	15.243	*
18 sample stocks	0.348	18.527	18.179	5,224
42 sample companies	6.794	146.786	139.992	2,061

*undefined

Source: Annual Statements, various years.

Table 3

Federal Income Taxes Incurred
($ in billions)

	1979	1980	1979-80 Change		1981	1980-81 Change	
			Dollar	Percent		Dollar	Percent
Prudential	$0.380	$0.120	$(0.260)	(68)%	$0.032	(0.088)	(73)%
Metropolitan	0.343	0.078	(0.265)	(77)	0.129	0.051	65
10 largest mutuals	1.524	0.966	(0.558)	(37)	0.615	(0.351)	(36)
24 sample mutuals	1.837	1.247	(0.590)	(32)	**	**	**
10 largest stocks	0.535	0.495	(0.040)	(7)	0.512	0.017	3
18 sample stocks	0.670	0.635	(0.035)	(5)	**	**	**
42 sample companies	2.507	1.882	(0.625)	(25)	**	**	**

** not available

Source: Annual Statements, various years.

ENCLOSURE

ENCLOSURE

FIGURE 1
MODIFIED COINSURANCE REPORTED BY THE
TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)

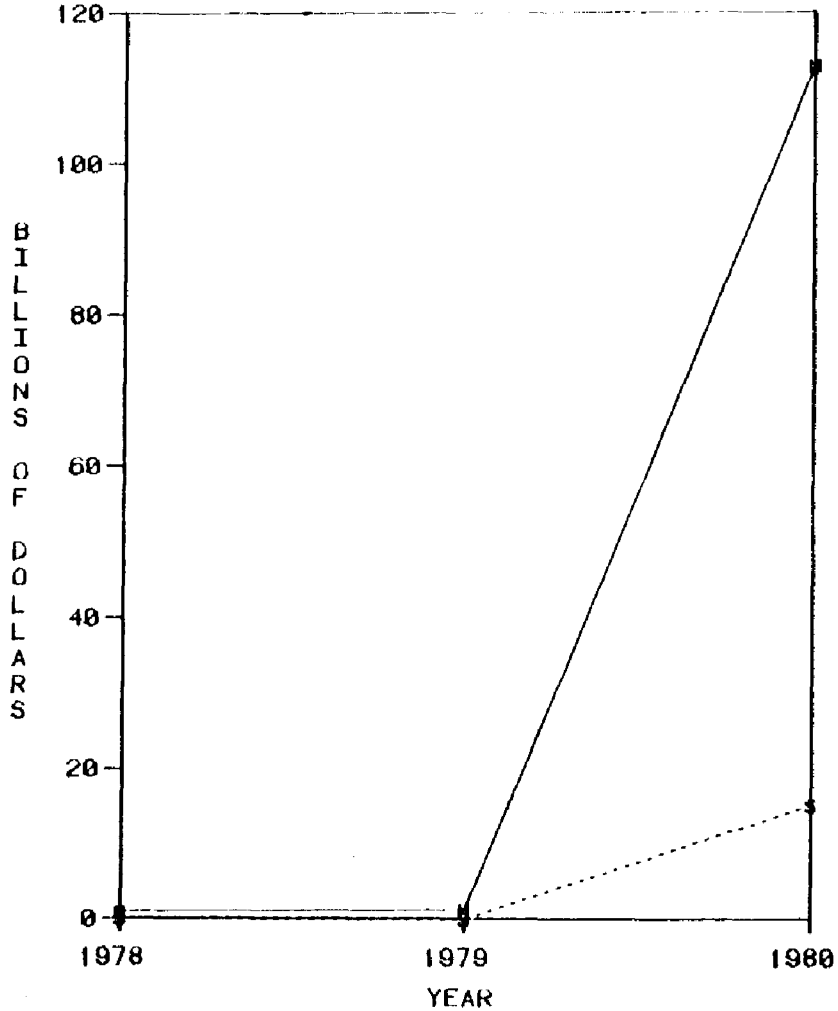
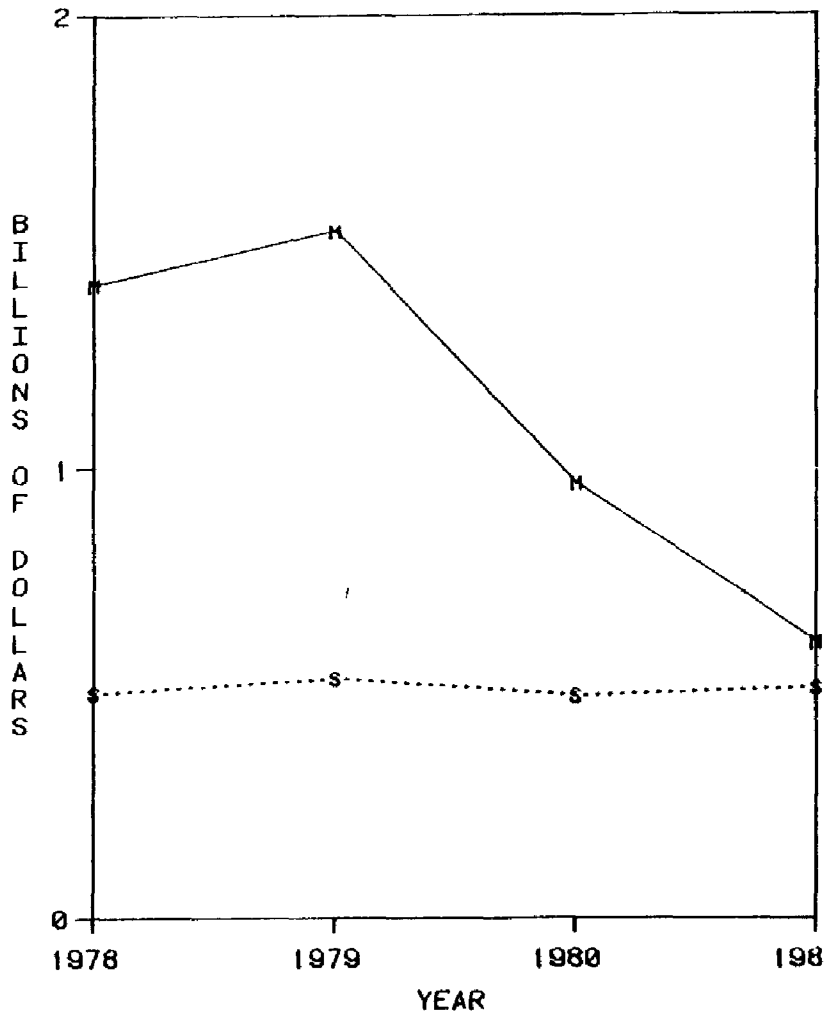


FIGURE 2
FEDERAL INCOME TAXES INCURRED FOR THE
TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)



ENCLOSURE

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FIGURE 3

MODIFIED COINSURANCE REPORTED BY 42 SAMPLE COMPANIES
24 MUTUALS (M) AND 18 STOCKS (S) AND TOTAL SAMPLE (T)

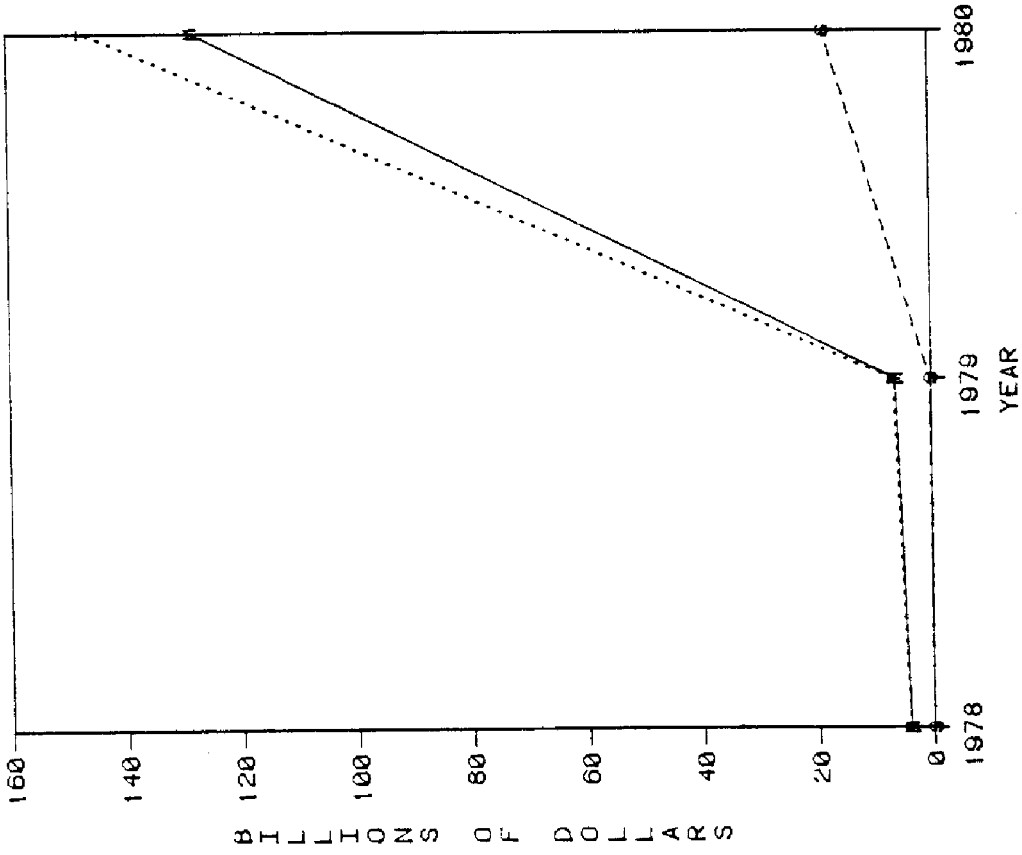

FIGURE 4

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

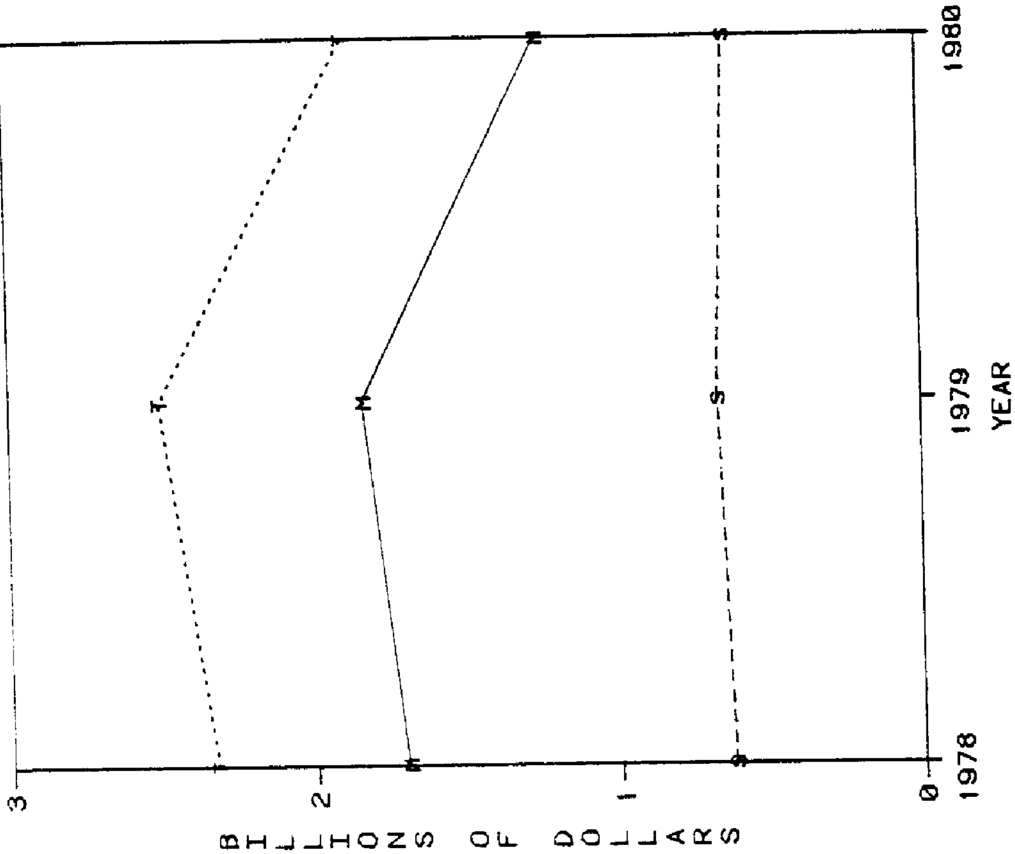

Table 4

Estimated Revenue Losses
($ in billions)

	Estimated Taxes Assuming No Section 820	Estimated Taxes Incurred	Estimated Revenue Losses
1978	$2.994 a/	$2.994 a/	$ --
1979	3.479 b/	3.269 a/	0.210
1980	4.043 b/	2.551 a/	1.492
1981	4.699 b/	1.242 c/	3.457

a/Life Insurance Fact Book, p. 64.

b/Projected at an annual growth rate of 16.21 percent, the geometric mean of the growth rates of the preceding 3 years. This compares to the ACLI/industry estimate of 15 percent annual growth rate.

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

Figure 5

Estimated Tax Incurred With (M) and Without (W) Section 820 Election