CHAPTER 12

FINANCIAL INSTITUTIONS

Part A. Commercial Banks and Thrift Institutions

This Part discusses proposals to conform special rules relating t the taxation of banks and thrift institutions to the general rules for the taxation of corporate income. The special bad debt reserve deduction for banks and thrift institutions would be repealed. Interest allocable to tax-exempt obligations held by banks, savings and loans, and certain other thrift institutions would be deductible. The tax exemption of credit unions and special reorganization rules for failing thrift institutions would be repealed.

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REPEAL SPECIAL RULES FOR BANK BAD DEBT DEDUCTIONS

General Explanation

Chapter 12.01

Current Law

Commercial banks and thrift institutions are generally subject to the corporate income tax, but receive preferred tax treatment that permits them to deduct additions to reserves for bad debts using a method unrelated to their actual loan loss experience.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loan method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Treasury Department proposals would require generally that bad debt losses be deducted only as they occur. See Chapter 10.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for all taxable years beginning on or after January 1, 1986. Depository institutions would be required to include existing reserves in income over ten years, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is to increase the after-tax income of depository institutions. The lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates. The proposal would eliminate this subsidy.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loan reserve method permits a bank to maintain a reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from $1.41 billion in 1979 to $0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 10.04.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are clearly a large subsidy for most savings and loan associations and commercial banks and a significant distortion from the measurement of economic income.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

General Explanation

Chapter 12.02

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations), incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. A statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

The corporate mimimum tax generally does not apply to interest received by banks and financial institutions from the holding of tax-exempt obligations.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Brokers and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example, if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. The prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on such a transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent

(9 x [1 - (.46 x .8)]) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Viewed in isolation, this proposal would tend to reduce bank demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Treasury Department proposals, however, would affect the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of non-governmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by state and local governments.

Table 1

Distribution of Tax-Exempt Securities and Loans -- 1983

	Outstanding Tax-Exempt Bonds Amount (In Billions)	Percent
Households	$173.8	35.9
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$484.6	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83

REPEAL TAX EXEMPTION FOR CREDIT UNIONS

General Explanation

Chapter 12.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. Their tax-exempt status has enabled credit unions to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Credit unions accounted for 5.7 percent of small time and savings deposits and 13.8 percent of consumer installment credit outstanding in 1983.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should thus be subject to tax on the same basis as other financial institutions.

Proposal

The tax exemption for credit unions would be repealed. Credit unions would be subject to tax under the same rules that apply to other thrift institutions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows credit union customer/owners to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for credit unions to retain, rather than distribute, current earnings.

The proposal will subject credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, credit unions will have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. Some of the retained earnings would be distributed currently and taxed at the individual level; the remaining amounts would be subject to tax at the company level.

REPEAL REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

General Explanation

Chapter 12.04

Current Law

Certain acquisitions of the stock or assets of one corporation by another qualify as tax-free reorganizations under current law. In general, the shareholders of a corporation that is acquired in a reorganization may exchange their stock for stock of the acquiring corporation on a tax-free basis. In addition, a corporation acquired in a reorganization may exchange its assets on a tax-free basis for stock of the acquiring corporation.

Corporate acquisitions generally do not qualify as tax-free reorganizations unless they satisfy the "continuity of interest" requirement. Stated generally, an acquisition will satisfy the continuity of interest requirement only if the shareholders of the acquired corporation receive a significant, continuing equity interest in the acquiring corporation.

Special rules enacted in 1981 permit the acquisition of a "financially troubled" thrift institution to qualify as a tax-free reorganization without regard to the continuity of interest requirement. The continuity of interest requirement would generally pose an obstacle in such an acquisition because depositors are the only persons holding interests in the financially troubled thrift who would receive an interest in the acquiring corporation. Because of their insured position, however, the depositors in the failing thrift generally will not accept an equity interest in the acquiring corporation with its attendant risk of loss. For this reason, the acquiring corporation ordinarily will assume the failing thrift's liabilities to its depositors. In the absence of the special waiver, an interest as a depositor would not satisfy the continuity of interest requirement.

For the special rule to apply, the Federal Savings and Loan Insurance Corporation (FSLIC), Federal Home Loan Bank Board (FHLBB), or, where neither has supervisory authority, an equivalent State authority, must certify that the transferor thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. In addition, the transferee must acquire substantially all of the transferor's assets and must assume substantially all of its liabilities. If an acquisition of a failing thrift institution satisfies these rules, the tax attributes of the failing thrift survive the acquisition and the acquiring corporation can use the net operating losses of the acquired thrift to lower its own taxable income.

In addition to the special reorganization rule, present law provides an exclusion from income for payments by the FSLIC to a thrift institution in connection with a reorganization. Such payments are not included in the thrift's gross income and do not reduce the thrift's basis in any of its assets.

Reasons for Change

The special rules governing reorganizations of financially troubled thrift institutions were enacted in 1981 to facilitate mergers and reorganizations of the then-ailing thrift industry. In such acquisitions, a profitable financial institution typically agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses.

Thrift institutions and their shareholders should be subject to tax on the same basis as other business enterprises. The special rules for reorganizations of financially troubled thrift institutions depart from that objective, and effectively shift some of the burden of thrift losses to the Federal government. If such subsidization of reorganized financial institutions is necessary, it should be effected through direct appropriations. This would permit the appropriate regulatory agency to determine the need for and amount of a subsidy on a case-by-case basis.

Proposal

The special reorganization rules for acquisitions of financially troubled thrifts and the exclusion from income of FSLIC payments to thrift institutions in connection with a reorganization would be repealed.

Effective Date

The repeal of the special reorganization rules would be effective for acquisitions occurring on or after January 1, 1986. The repeal of the exclusion for certain FSLIC payments would apply to taxable years beginning on or after January 1, 1986.

Analysis

The Federal assistance provided through special tax rules hides the total subsidy cost and is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations.

Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return than is available on investments whose income is fully taxed on a current basis. The Treasury Department proposals would do away with this special treatment. Deferral on the income earned on the investment of life insurance premiums (other than term insurance) wuld be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts. Policyholder loans and partial withdrawals would also be taxed to the policyholder, to the extent of any income credited to the policy but not previously taxed to the policyholder.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE INSURANCE INSIDE INTEREST BUILD-UP

General Explanation

Chapter 12.05

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts in the nature of interest to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns interest for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside interest build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as interest is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the contract have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment vehicles offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment vehicle, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside interest build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Interest income on comparable investment vehicles generally is not tax free or tax deferred. Instead, interest income credited on such investments generally is subject to tax whether or not the interest is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside interest build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to lower income taxpayers and other individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside interest build-up encourages individuals to save through life insurance companies rather than other financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy.

The investment component of a long-term life insurance contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a life insurance contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all inside interest build-up credited to policies sold on or after January 1, 1986. In the case of policies outstanding on December 31, 1985, inside interest build-up would continue to be free from tax until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future inside interest build-up on policies sold before January 1, 1986 would be fully subject to tax starting in 1995. Deferral of untaxed inside interest build-up would continue until withdrawal of funds from the policy. See Chapter 12.06. The policyholder's investment in the contract would not be reduced by the cost of term insurance for any period prior to January 1, 1986.

Analysis

Taxing the inside interest build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Current taxation of inside interest build-up also would eliminate the need for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance. For a discussion of how this proposal would affect the treatment of policyholder loans, see Chapter 12.06.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred interest income earned on life insurance and annuity policies in 1983 is estimated at $3,050 for families with income greater than $200,000 and less than $200 for families with income less than $30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside interest build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 1

Distribution of Ownership of Cash-Value Life Insurance Policies and the Annual Inside Interest Build-up 1/
By Economic Income - 1983

Family Economic Income	Families with Cash-Value Life Insurance Policies Percentage	Average Annual Inside Build-up 2/
$ 0 - 9,999	13	$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42	$ 355

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Includes annuities.
2/ For those with policies.

Source: Treasury estimates.

It is anticipated that many low- and middle-income individuals who currently own relatively small amounts of cash value life insurance and who would not otherwise maintain IRAs will designate their existing policies as IRAs. If the annual premium (net of policyholder dividends) plus the inside interest build-up on the policy does not exceed the applicable IRA limit, the inside interest build-up would continue, in effect, to be free from current tax. However, the rules respecting the timing of distributions from IRAs would apply and any cash value held in a life insurance IRA at the policyholder's death would be taxed to the beneficiary like any other IRA distribution. (The excess of the death proceeds over the cash value would be exempt from tax, as under current law.)

REVISE TAXATION OF POLICYHOLDER LOANS AND PARTIAL WITHDRAWALS

General Explanation

Chapter 12.06

Current Law

Life insurance policies normally permit the policyholder to borrow funds from the life insurance company in an amount up to the cash value of the policy. Until repaid, the amount of a policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder.

Policyholder loans are respected as loans and are not treated as withdrawals from the policy, even if the loans are not repaid prior to the death of the insured. Moreover, subject to certain restrictions, interest paid on policyholder loans is deductible by the policyholder even though the policy's inside interest build-up is not subject to current tax.

Generally, if a policyholder withdraws cash from his policy, he is treated as recovering first his investment in the policy. Only after the entire investment has been recovered is the excess amount withdrawn subject to tax. However, a special rule in the definition of life insurance provides that if cash is withdrawn from a policy as a result of a reduction of future death benefits under the policy, the cash will be treated as "boot" in an exchange transaction and subject to tax.

Reasons for Change

Because the inside interest build-up on life insurance policies is not taxed until withdrawal, and is not taxed at all if the policy is held until death, interest deductions from policyholder loans can be used to shelter other taxable income. Currently, life insurance companies are able to market policies with fixed borrowing schedules that provide substantial tax advantages to the policyholder. Under some of these plans, the tax advantages are so large that they have been marketed primarily as tax shelters and only incidentally as life insurance.

Through a partial withdrawal of the cash surrender value from a life insurance policy, a policyholder may receive back an amount that does not exceed his investment in the policy free from tax. A policyholder should not be allowed to cash in his investment while continuing to defer the payment of tax on income from that investment.

Borrowing against the cash value of a life insurance policy reduces the total amount invested by the individual in the policy and has the effect of a partial withdrawal of the policy's cash surrender value. These economically equivalent transactions should be accorded equivalent tax treatment.

Although current taxation of inside interest build-up is proposed in Chapter 12.05, the transitional rule under that proposal would permit the continued deferral of tax on certain inside interest build-up for policies outstanding on December 31, 1985. Accordingly, even if the proposal in Chapter 12.05 is adopted, a revision of the policyholder loan and partial withdrawal rules is needed as a temporary measure.

Proposal

Policyholder loans and partial withdrawals under a policy (not including policyholder dividends and similar distributions), to the extent of any income credited to the policy but not yet included in the taxable income of the policyholder, would be treated as a distribution of such income to the policyholder. The amount of income treated as distributed to the policyholder would be limited to the excess of the cash surrender value of the policy (taking into account any surrender charge or penalty) over the policyholder's investment in the contract. The policyholder's investment in the contract would equal the aggregate amount of premiums paid for the contract reduced by the sum of the aggregate amount of policyholder dividends and similar distributions and the aggregate cost of insurance, taking into account only the cost of insurance after December 31, 1985.

Effective Date

The proposal would apply to policyholder loans and partial withdrawals made on or after January 1, 1986. In addition, all policyholder loans outstanding on December 31, 1985, to the extent not repaid before January 1, 1991, would be treated as new loans to which the proposal applies.

Analysis

The treatment of policyholder loans and partial withdrawals as distributions coming first out of any untaxed investment income under the policy ensures that the tax deferral of inside interest build-up occurring prior to the effective date of these proposals will continue only as long as savings and investment income are retained in the policy. The treatment of outstanding loans not repaid before January 1, 1991 as new loans subject to the proposal would reduce an otherwise strong incentive for policyholders to withdraw funds through policyholder loans shortly before the effective date of the proposal.

The need for this rule (and for the provisions of current law prescribing special treatment of policyholder loans) will disappear after all policies containing untaxed inside interest build-up mature or are surrendered. However, if the proposal in Chapter 12.05 to tax currently the inside interest build-up on life insurance policies is not adopted, this proposal would be needed as a permanent rule.

IMPOSE CURRENT TAXATION ON DEFERRED ANNUITY INVESTMENT INCOME

General Explanation

Chapter 12.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposits is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts (IRAs). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in interest income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract.

A deferred annuity contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a deferred annuity contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all investment income credited to contracts sold on or after Jauary 1, 1986. In the case of contracts outstanding on December 31, 1985, investment income credited to the contracts would continue to be untaxed until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future income credited to contracts outstanding on December 31, 1985 would be fully subject to tax starting in 1995. Deferral of untaxed investment income credited to a contract would continue until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions on or after January 1, 1986. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would permit the efficient flow of long-term savings.

Since life insurance companies selling deferred annuities are accustomed to designing investment vehicles to provide for policyholders' retirement, it can be anticipated that companies currently selling deferred annuities will be able to compete effectively for IRA investments. For example, life annuities sold by life insurance companies are the only financial instrument to insure against living beyond one's wealth after retirement. An IRA maintained with a life insurance company may be attractive to investors since a life annuity is available as a direct settlement option, avoiding the need for a rollover from an IRA maintained with another financial institution into a separate annuity IRA upon retirement.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Chapter 12.05, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an interest-bearing account. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy. This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to give to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserves for any contract would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). The reserve deduction would be adjusted to reflect the indexing of interest. See Chapter 9.03.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Chapter 12.05, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 12.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base for competing financial institutions. Enactment of comprehensive tax reform that affects all financial institutions and reduces the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective marginal tax rate to 36.8 percent. The Treasury Department proposals would lower the corporate rate to 33 percent.

Small life insurance companies would be placed on a par with all other life insurance companies and other small corporations. Elimination of preferential tax rates based on the size of the firm would end tax-induced distortions that favor sales of life insurance through small firms.

Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty (P&C) insurance companies. The deduction for estimated unpaid losses, which is currently allowed on an undiscounted basis, would be allowed only to the extent of the discounted present value of the losses. Special provisions that reduce the effective tax rate on P&C insurance companies would be eliminated. Thus, the deduction for contributions to a protection against loss account would be repealed. The deduction for policyholder dividends by mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

LIMIT PROPERTY AND CASUALTY INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under traditional tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future.

Reasons for Change

The deduction of additions to reserves, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for additions to reserves are allowed, such as for life insurance companies, the allowable reserves are discounted for the expected future investment earnings on the reserve funds. The reserve deduction available to P&C companies should also be discounted.

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by the self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's <u>after-tax</u> rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year.

The initial reserve with respect to a policy could not exceed the premiums received under the policy reduced by the share of the company's deductible sales and administrative expenses allocated to the policy. Beyond this, the company would not be subject to federally prescribed rules for discounting future losses in establishing the reserve account. Instead, the company would be free to use any reasonable discounting method (e.g., the same estimates it used in pricing its insurance policies).

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. This would ensure that, if the company's estimates of the amount and timing of claims and after-tax rate of return on investment assets were accurate, the reserve would be exhausted and the last claim would be paid simultaneously. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it felt was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid or reduce a large income item in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

Effective Date

The proposal would be effective for all unpaid losses with respect to all policies issued on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The discounting of losses, however, would prevent the reserve deduction from yielding greater tax benefits than a deduction claimed at the time the losses are paid or accrued. Discounting the amount of allowable reserves for tax purposes would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. For instance, individual taxpayers can claim a casualty loss deduction on personal property only for the amount of loss in excess of ten percent of the individual's adjusted gross income. Deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. In the case of medical malpractice and workers'

Table 1

Timing of Loss Payments to Total Losses Incurred
by Major Lines of Business of Property and Casualty
Insurance Companies - 1975 to 1983 Experience

	Payments as Percent of Losses Incurred					
	Line of Business					
Time Between Loss Incurred and Payment	All Business	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred. 1/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

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1/ Discounted by the payment stream at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because many of the payments eight years or later are not fully discounted, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

compensation liabilities, payments on contested or uncertain liabilities generally are not deductible by the policyholder until payment is actually made nor is the "economic" loss to the injured party generally a deductible expense to such party.

It has also been argued that it is inappropriate to mandate the discounting of reserves for Federal tax purposes because P&C companies are generally underreserved (as a result of underestimating future claims). Under current law, however, even a company that has established an initial reserve equal to (or even less than) the present value of a future claim derives a significant benefit. For example, if a P&C company establishes a reserve of $792.09 for a future claim that it estimates will be $792.09, and if the claim turns out to be $1,000, the company will receive an additional deduction of $207.91 when the claim is paid, even though it received a full deduction (in present value terms) when the reserve was established.

The discounting of reserves for tax purposes would not affect State law requirements for reserves to protect policyholders against company insolvency. State law would continue to require adequate funding of statutory reserves. The tax reserve account would be smaller than the statutory reserve and would be only a bookkeeping entry. The lower tax reserve would increase the current tax liability of P&C companies and affiliated companies, but as described above the proposal would simply eliminate the deferral of tax liability allowed under current law. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The property and casualty industry may argue that this proposal is not appropriate for an industry with large underwriting losses (-$11.0 billion in 1983). However, as shown in Table 2, P&C companies earned total net income of $6.6 billion in 1983, this being the excess of their $17.9 billion of investment income over their underwriting losses. The large underwriting losses occur because P&C companies lower premiums (discount) for the expected future investment income, but they currently do not discount statutory reserves which are used in calculating underwriting income. Total net income is the appropriate measure of company profitability, not underwriting income.

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Table 2

Investment Gain and Underwriting Loss of Property and Casualty Insurance Companies - 1979 to 1983
(In millions of dollars)

Year	Net Underwriting Gain or Loss	Net Investment Gain or Loss	Other Miscellaneous Income	Total Net Income 1/
1979	$ - 21	$ 9,607	$ - 161	$ 9,424
1980	-1,819	11,628	- 208	9,601
1981	-4,563	13,520	- 265	8,692
1982	-8,302	15,479	- 406	6,771
1983	-11,033	17,923	- 306	6,584

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1/ Before policyholder dividends.

Source: Best's Aggregates and Averages.

The principal advantage of the qualified reserve account method of discounting reserves is that it assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. In fact, the qualified reserve account method would yield the same ultimate after-tax return as the cash method of accounting, although it would achieve a better matching of income and deductions on a year-by-year basis. This means that it would be unnecessary to prescribe a Federal standard for discounting reserves -- companies are free to discount using any reasonable set of assumptions (e.g., the assumptions used in pricing the policies). A company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 12.11

Current Law

Most mutual property and casualty (P&C) insurance companies are allowed deductions for net contributions to a protection against loss (PAL) account. A deduction is generally allowed for contributions to the account in an amount equal to one percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies that have a high percentage of risks relating to windstorms, hail, flood, earthquakes, or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing one percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of future losses. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 12.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty (P&C) insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other P&C companies and other small corporations. Elimination of preferential rates based on the size of the firm would end tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 12.13

Current Law

In general, stock and mutual property and casualty (P&C) insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Because policyholder dividends distributed by mutual companies are substantially larger than similar distributions by stock companies, this deduction primarily benefits mutual P&C companies.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The allowance of a deduction for income distributed in the form of policyholder dividends by mutual P&C companies provides a competitive advantage to such companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would ensure that corporate profits are taxed at least once, thereby reducing the distortion caused by the deduction.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.

Part D. Tax Exemption for Insurance Companies

REPEAL TAX EXEMPTION FOR CERTAIN INSURANCE COMPANIES

General Explanation

Chapter 12.14

Current Law

Current law exempts from Federal income tax a large and diverse group of nonprofit organizations. These organizations are, however, taxable on income received from the conduct of business that is unrelated to the organization's exempt purpose. Although the sale of insurance by tax-exempt organizations generally is an unrelated trade or business, there are numerous organizations that engage in the insurance business without tax liability. Current law expressly provides a tax exemption for the insurance activities of some organizations, including: certain fraternal beneficiary societies that provide for the payment of insurance benefits to their members; voluntary employee beneficiary associations that provide insurance benefits to their members; local benevolent life insurance associations; mutual insurance companies or associations (other than life or marine) if the gross amount received from certain sources does not exceed $150,000; trusts for the payment of supplemental unemployment benefits; Black Lung trusts; veterans' organizations; and shipowners' protection and indemnity associations. In addition, some organizations that sell insurance have been held to be tax exempt under provisions of law exempting from tax religious, charitable, or educational organizations and social welfare organizations.1/

Reasons for Change

The statutory tax exemptions for the organizations listed above generally were enacted at a time when large parts of the United States were rural and agricultural, and when many individuals and businesses were unable to obtain insurance from commercial companies. Similarly, tax-exempt status was recognized by the courts and the Internal Revenue Service for certain organizations because they met a need that was not met by the commercial sector. These organizations generally were small and had little income.

1/ Where an insurance organization's exempt status is not expressly mandated by statute but rather has been recognized under a more general provision for exempt status, the Internal Revenue Service has authority to revoke the organization's exemption if it is no longer justified.

Today, tax-exempt insurance companies are generally indistinguishable from their taxable counterparts. They sell the same products as taxable insurance companies and compete with taxable companies for business. Several insurance companies that are exempt from tax rank among the largest insurance companies in the United States.

All businesses that sell insurance should be treated equally. Retention of tax-exempt status for some insurance companies would give those companies an unfair competitive advantage. The absence of a tax burden on these companies may be reflected in lower premiums charged to policyholders, thereby giving individuals who are able to purchase insurance from one of these companies an advantage over other individuals.

Proposal

Existing tax exemptions for insurance businesses would be repealed. In general, these insurance businesses would be taxed under the rules applying to taxable corporations. Any organization qualifying as a life insurance company or property and casualty insurance company would be taxed under the rules applying to that type of company. Special rules would be provided for certain organizations that are not subject to the same system of regulation for State law purposes as other insurance companies or that have relatively small insurance activities.

The providing of insurance at less than cost to a class of charitable recipients would continue to be recognized as a charitable activity entitled to exemption from Federal income tax.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Nonprofit organizations providing insurance in competition with taxable stock and mutual insurance companies would be placed on a par with their competitors. Elimination of the tax exemption would end tax-induced distortions that favor the provision of insurance through tax-exempt organizations and that favor individuals who have access to insurance sold by these organizations.