REPORT # 536

TAX SECTION

New York State Bar Association

Report on Insurance Provisions of H.R. 3838

July 16, 1986

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Attached letter dated 7/16/86 enclosing report of the Insurance Companies Committee regarding comments on the House and Senate proposals in H.R. 3838 sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

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July 16, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

The enclosed report, prepared by the Committee on Insurance Companies of the Tax Section of the New York State Bar Association, comments on the House and Senate proposals in H.R. 3838 to revise the taxation of life insurance companies and their products.

Because of time constraints resulting from the imminent start of Conference Committee meetings, the report has not been considered by the Executive Committee of the Tax Section and thus represents the views only of the Committee on Insurance Companies.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen
Chairman

Enclosure
cc: The Honorable John Robert J. Duncan) with,
Robert J. Leonard, Esq.) enclosure

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REPORT # 536

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON INSURANCE COMPANIES

REPORT ON INSURANCE PROVISIONS OF H.R. 3838

July 16, 1986

REPORT ON INSURANCE PROVISIONS OF H.R. 3838

I. INTRODUCTION

A. General

The tax reform proposals now before Congress contain a number of provisions that will significantly affect the insurance industry. This report discusses the insurance-related provisions that appear to be of greatest importance.[1] For purposes of this report, the proposals are grouped into five sections: (1) life insurance provisions; (2) property/casualty insurance company provisions; (3) alternative minimum tax provisions of importance to insurance companies; (4) policyholder or product provisions; and (5) miscellaneous items.[2] The first part of each section of the report discusses a proposal set out in H.R. 3838, as approved by the House of Representatives on December 17, 1985

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[1] This report was prepared by Committee Co-Chairman Hugh T. McCormick and Donald C. Alexander. Helpful comments were made by Norman C. Bensley, Peter J. Connors, David M. Sadkin, John W. Weber, Jr., Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Dale S. Collinson, Peter L. Faber and Michael L. Schler.

[2] This report does not discuss the structured settlement provisions of H.R. 3838. Those provisions will be discussed in a separate report of the Committee.

(the “House Bill”). The second part sets out the corresponding proposal in the Senate Finance Committee version of H.R. 3838, as approved by the Senate on June 24, 1986 (the “senate Bill”). The third part will set out Committee comments.

B. Summary of Comments

The major focus of the Tax Reform Bill proposals with respect to insurance companies is on the property/casualty segment of the industry, largely as a result of a strong feeling in both the Treasury Department and the Congress that the current tax rules applicable to members of this segment result in a serious mismeasurement of taxable income. See H. Rep. No. 426, 99th Cong., 1st Sess. 669 (December 7, 1985). The Committee believes that a comprehensive revision of the taxation of such companies is appropriate and timely. As will be noted below, we generally support the provisions set out in the Senate Bill.

In addition, there are provisions concerning life insurance companies and their products. In light of the overall restructuring of the taxation of life insurance companies in 1984, however, the life insurance company provisions are for the most part narrowly drawn and

technical in nature. The Committee agrees with this approach, as we believe that it is too soon after the revision of the tax rules for life insurance companies to implement significant changes. As will be discussed below, however, we take issue with certain of the provisions affecting policyholders and products, as well as the effective date of the general tax rate reduction.

Finally, the Committee believes that the alternative minimum tax "book income" preference item, as currently proposed in the Senate Bill, will generally result in disparate and inequitable treatment of otherwise similarly situated insurers, and will give rise to other problems as well. Therefore, we oppose this provision. If the book income preference item is retained in the Tax Reform Bill, however, we believe it will be necessary to make adjustments to the technical rules of the provision to accommodate the particular structure and operations of the insurance industry.

II. LIFE INSURANCE COMPANY PROVISIONS

A. Tax Rate Reduction -- Repeal of Special Life Insurance Company Deduction

1. House Bill § 1011: Under present law a life insurance company subject to tax under Part I of Subchapter L of the Internal Revenue Code of 1954, as amended

(the "Code"), is allowed a special deduction equal to 20% of its income from its insurance business (including certain investment income). Section 806 of the Code. The purpose of the deduction is to set the maximum effective tax rate on a life insurance company's insurance operations at 36.8%, and thereby reduce the tax impact of the changes in life insurance company taxation brought about by the Deficit Reduction Act of 1984 ("DEFRA").

The House Bill would reduce the maximum general corporate income tax rate from 46% to 36%. According to the House Ways and Means Committee Report on H.R. 3838, the special rate for life insurance companies is no longer appropriate in light of the overall corporate rate reduction, and therefore the special deduction should be repealed. See H. Rep. No. 426, supra, at 662 (December 7, 1985).

2. Senate Bill § 1011: The Senate Bill sets the maximum corporate income tax rate at 33%, rather than 36%, and would also repeal the special life insurance company deduction. The Senate Finance Committee Report also states that the lower rate structure for all corporations makes the special deduction no longer appropriate, and points out that Congress never intended that life insurance companies would always be taxed at generally

lower tax rates than other corporations. See S. Rep. No. 313, 99th Cong., 1st Sess. 491 (May 29, 1986).

3. Comment: The Committee believes that the elimination of the special life insurance company deduction and the overall rate reduction should occur at the same time. If the tax rate reduction does not become effective until July 1, 1987, as is provided under the Senate Bill, but the special life insurance company deduction is eliminated at the beginning of the year, the pre-July 1, 1987 effective tax rate on all life insurance company income will be 46%, rather than 36.8%. We believe that if the elimination of the deduction and the rate reduction occur at different times, the 1987 "blended rate" for a life insurance company should be based on the pre-July 1, 1987 effective rate of 36.8% for the company's life insurance business. Thus, a transition rule should be designed to give such companies the benefit of the special life insurance company deduction for the portion of the year during which the higher rate structure is in effect.

B. Operations Loss Deduction of Insolvent Companies

1. House Bill § 1013: Under the Life Insurance Company Tax Act of 1959 stock life insurance companies were permitted to exclude from taxable income 50% of

the excess of gain from operations (underwriting income and investment income) over investment income, and were permitted special deductions with respect to certain lines of business. The excluded underwriting income and the special deductions were added to a deferred tax account which is known as the policyholders surplus account (the “PSA”). Although the tax regime under the 1959 Act was eliminated by DEFRA, thus ending additions to the PSA, existing accounts continue at their pre-1984 levels.

The PSA is subject to restoration to income in certain instances, such as when the account becomes disproportionately large with respect to the company's current operations (as measured by premiums or reserves), or when the company ceases to be a life insurance company. Code section 815. (The income reported upon restoration of the PSA is known informally as “Phase III income.”) When a life insurance company becomes insolvent and is liquidated both of these conditions can occur. As a general matter a life insurance company is not permitted to use current or carryover operating losses against Phase I11 income. Thus, under present law when a stock life insurance company is liquidated as a result of its inability to cover policyholder liabilities, its already diminished ability to pay such liabilities can be further impaired by its Phase I11 tax liability.

The House Bill provides that an insurance company that was insolvent on November 15, 1985, and that is liquidated pursuant to a state liquidation proceeding, is permitted to use its current and carry forward operating losses against Phase III income. Under this provision operating losses of the company in excess of those used against Phase III income will be eliminated.

2. Senate Bill **§** 1012: The Senate Bill provision is substantially the same as the House Bill provision.

3. Comment: The Committee believes that the relief offered by this proposal is appropriate. We note that this proposal was initiated to cover a particular insurer, and is intended to be limited in its application. See S. Rep. No. 313, supra, at 492. We believe, however, that a relief provision of this nature should be added to Code section 815 as a permanent measure. There are two bases for this recommendation:

First, the PSA was set aside for the purpose of fulfilling policyholder contracts and is brought into income when the amounts so set aside are made available to shareholders. See H. Rep. No. 34, 86th Cong., 1st Sess. (February 13, 1959), 1959-2 C.B. 788. Clearly, in an insolvency there is no amount available for distribution

to shareholders, as all available funds are generally paid to policyholders or other creditors.[3]

The second basis is simple equity. To the extent that the tax is collected from the insolvent insurer, payments to policyholders and other creditors are reduced accordingly. Moreover, in many cases such reduction is reflected in increased claims against state insurance guaranty funds. As assessments paid by insurers into such funds can frequently be credited against state premium taxes, the economic impact of the tax is passed through to the states. Thus, if the Phase I11 tax is collected from an insolvent stock life insurer (which generally has extensive losses), the policyholders or the states bear the economic burden of the tax, rather than the enterprise itself or its owners.

In light of these considerations we believe that Code section 815 should be amended to allow the use

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[3] The "phase III" account is triggered when certain limits are reached, or when a company ceases to be a life insurance company, regardless of whether amounts have been distributed to shareholders. Both of these triggering events appear to be based on the assumption that the set-aside is no longer needed for policyholder protection purposes. In an insolvency, however, virtually every dollar is dedicated to insurance-related liabilities.

of operating losses against Phase III income when insurance companies are placed in insolvency proceedings.[4]

C. Taxation of Tax-Exempt Insurers

1. House Bill § 1012: The House Bill would eliminate tax-exempt status for certain insurance organizations, such as TIAA-CREF, the Blue Cross/Blue Shield companies and church pension boards, that are now tax exempt under Code sections 501(c)(3) (charitable organizations) or 501(c)(4) (social welfare organizations). Moreover, the House Bill would treat as unrelated business certain "commercial-type" insurance activities of other tax-exempt organizations. Commercial-type insurance activities include the sale of annuities, but do not include church property insurance operations where only church property or personnel are covered.

2. Senate Bill § 1825(f): The Senate Bill contains no provision to eliminate tax-exempt status for insurance organizations that are exempt under present law. The Senate Bill does, however, contain a provision

[4] The liquidation of an insolvent insurance company raises a variety of complex tax issues. The Committee believes that a comprehensive legislative approach to such issues is necessary. The Committee has initiated a project on insurance company insolvency issues, and will prepare a report on possible legislation.

confirming that church self-funded death benefit plans will be treated as life insurance plans for purposes of Code sections 79, 101(a) and 7702.

3. Comment: The Committee generally takes no position on the House Bill provision. It should be observed, however, that organizations that primarily offer retirement oriented contracts fill a role ordinarily filled by tax-exempt pension trusts. Thus, continued tax-exempt status for such organizations does not appear to be inappropriate. In particular, the Committee understands that the House Bill provision was not originally intended to cover church pension boards. We do not believe that such organizations should be taxed as insurance companies.

The church death benefit plan provision in the Senate Bill is a technical correction intended to cure an inadvertent problem caused by the definition of "life insurance" under Code section 7702. See S. Rep. No. 313, supra, at 991. The Committee supports this proposal.

III. PROPERTY/CASUALTY INSURANCE COMPANY PROVISIONS

A. Reduced Deduction for Unearned Premiums

1. House Bill § 1021: Under present law a mutual or stock property/casualty insurance company (i.e., a company taxed under Part II or III of Subchapter L, and referred to herein as a "P/c" company) is permitted to expense its policy acquisition costs and to defer the recognition of premium income until the premium is It "earned" (which occurs ratably over the life of the insurance contract). According to the House Ways and Means Committee, this combination, which follows statutory accounting principles (or "SAP," as required for the NAIC Annual Statement filed with state insurance regulators) with respect to these items, results in a significant mismatch of income and expense items, in comparison to general tax accounting concepts. See H. Rep. No. 426, supra, at 669. In order to bring about a proper match, the House Bill would require a P/C company to reduce its deduction for unearned premiums by 20% each year. It would also require the inclusion in income of 20% of the unearned premium reserve outstanding at the end of the last taxable year prior to the effective date of the House Bill, ratably over a five-year period. Accordingly, under the House Bill a total of 20% of pre-1986 unearned premium reserve

would be included in income, at the rate of 4% per year over the five years beginning after 1985.

2. Senate Bill § 1021: The Senate Bill contains a similar proposal, although it would extend the period for inclusion of 20% of the existing reserve to seven and one-half years. Also, the Senate Bill addresses the concerns of insurers of municipal bonds and other long-term securities, which typically have relatively large unearned premium reserves, as premiums for such coverage are usually fully paid at the time the bonds are issued, but earned over the life of the bond. Under the Senate Bill the unearned premium inclusion percentage is 10% for policies insuring the payment of principal and interest with respect to securities with a five year or greater maturity. Also, the Senate Bill excludes life insurance reserves (i.e., reserves computed under the rules of Code section 816 that are included in unearned premiums) of a P/C company from the 20% inclusion rule.

3. Comment: The Committee believes that the underlying premise of both proposals, that the application of present law can result in a mismatch of income and deductions, is sound and that the proposed treatment of the unearned premium reserve achieves an acceptable

result. Further, we believe that the special rule for bond insurers is appropriate. Thus, we support the Senate Bill provision.

B. Reduced Deduction for Loss Reserves

1. House Bill § 1022: Under the House Bill the deduction for loss reserves would be reduced by a portion of the P/C company's tax-exempt interest and the deductible portion of dividends received. The reduction rate is 10% for taxable years beginning after December 31, 1985, and increases to 15% for taxable years beginning after December 31, 1987. The proration rule would not apply to interest and dividends on stock or obligations acquired before November 15, 1985.

2. Senate Bill § 1022: The Senate Bill deletes the House Bill proposal and replaces it, and the special insurance company minimum tax (discussed below), with a reserve discounting rule, as follows:

a. The Senate Bill provides that each line of business of a P/C company is to be discounted. For purposes of the Senate Bill, the term "losses" includes both unpaid losses and unpaid loss adjustment expenses.

b. The discount rate is to be 5% for accident years beginning before or in 1987. For years after 1987 the discount rate would be 75% of the average of annual

Federal mid-term rates (as defined in Code section 1274(d)) determined over a 5-year base period.

c. The Senate Bill would give the Secretary the authority to determine industry loss payment patterns for each line of business. For computational purposes the loss payment patterns for "short-tail" lines (generally, as shown on Schedule O of the Annual Statement) would be based on the "accident year" and the three subsequent years. For "long-tail" lines (e.g., workmen's compensation, medical malpractice insurance or other lines shown on Schedule P of the Annual Statement) the pattern would be based on the accident year and ten succeeding years. There is a special computational rule for lines with longer loss payment patterns. The Senate Bill also provides that companies may elect to use their own loss payment patterns.

d. Certain lines of business are subject to special rules. In particular, although international and reinsurance lines are shown on Schedule O, composite discount factors for such lines would be derived by combining the payment patterns for all Schedule P long-tail lines. Furthermore, while no election to use a company's experience would be permitted on such lines, the Secretary is authorized to issue regulations requiring a company to use a different loss payment pattern. Also, under the Senate

Bill life insurance and certain accident and health lines would be subject to life insurance reserving rules.

e. The Senate Bill provides a “fresh start” adjustment so that the change in law would not produce a tax windfall.

3. Comment: The House Bill provisions with respect to tax-exempt interest and dividends (as well as the special minimum tax proposal discussed immediately below) are intended to be part of a “stop-gap” measure to substantially increase the total amount of revenue collected from the P/C industry, while allowing Congress an opportunity to restructure the tax regime for P/C companies. On the other hand, the Senate Bill discounting proposal, which is largely based on an industry proposal offered in response to the House Bill, is viewed as a permanent measure.

The Committee believes that a permanent measure that both raises the target amount of revenue, and is backed by major components of the affected industry, is preferable to a stop-gap measure.

C. Special P/C Insurance Company Minimum Tax

1. House Bill § 1023: The House Bill would impose a 20% alternative minimum tax on "net gain from operations." The tax base is determined with reference to line 18(b) of the Annual Statement, which refers to net income (including tax-exempt income) in excess of policyholder dividends, but before taxes. The alternative minimum tax is, in effect, a tax on accretions to the surplus of the company. Net operating loss carryovers would not be available to offset this item. The most significant aspect of this proposal is that its effective date is delayed until 1988. In reality, this minimum tax is not intended to take effect, but is intended to spur the P/C industry to participate in an overall restructuring of P/C taxation over the next two years.

2. The Senate Bill deletes this special minimum tax proposal in favor of the reserve discounting rule discussed above. It should be noted that the general corporate alternative minimum tax proposed in the Senate Bill (discussed in Part III of this report) could have a significant effect on P/C companies, however.

3. Comment: As noted above, the Committee generally supports the permanent solution offered in the

Senate Bill. As will be more fully discussed in Part III, however, we believe there are substantial difficulties raised by the application to insurance companies of the general alternative minimum tax proposed in the Senate Bill.

D. PAL Account

1. House Bill § 1024: The House Bill would repeal the deduction for additions to the protection against loss ("PAL") account that is now available to mutual P/C companies under Code section 824. The PAL account, which is a memorandum account allowing the mutual to defer the recognition of a portion of underwriting income for up to five years, was enacted to provide a partial "cushion" against unusual losses. The House Ways and Means Committee Report takes the position that the PAL account does not perform its intended role, and therefore the deduction should be eliminated. See H. Rep. No. 426, supra, at 676. The existing PAL account would be brought into income over five years.

2. Senate Bill § 1023: The Senate Bill would also eliminate the PAL account.

3. Comment: The Committee takes no position on this proposal, except to note that it appears to be

consistent with the often-discussed "level playing field" concept of insurance taxation.

E. Special Rule for Small Mutuals

1. House Bill § 1025: The House Bill would repeal the tax-exemption for certain small mutuals under Code section 501(c)(15), and would repeal other provisions applicable to small taxable mutuals. In place of the repealed rules the House Bill would exempt from tax any P/C company with premiums of less than $500,000, and would allow a company with premiums of less than $2,000,000 to elect to be taxed on investment income only.

2. Senate Bill § 1024: The Senate Bill contains a provision similar to the House Bill, except that the key amounts are $350,000 and $1,200,000

3. Comment: The Committee believes that a simplification of the rules applicable to small insurers is appropriate, but takes no position with respect to the threshhold amounts.

F. Study of Policyholder Dividends of Mutual Companies

1. House Bill § 1026: Under present law a P/C company, whether stock or mutual, is allowed a full deduction for dividends paid to policyholders. Under the

rules applicable to life insurance companies, however, a mutual's policyholder dividend deduction is reduced in order to reflect the concept that the mutual company is owned by its policyholders and that the dividend is both a price reduction and a return on equity that is being distributed to owners. According to the House Ways and Means Committee Report, Congress realizes that the full deductibility of policyholder dividends may give mutual P/Cs a competitive advantage over stock P/Cs. The Report suggests, however, that a study of the issue is necessary in order to determine the best method of correcting this theoretical imbalance. See H. Rep. No. 426, supra, at 678.

2. The Senate Bill contains no similar provision.

3. Comment: The Committee believes that the study proposed in the House Bill is appropriate. We suggest, however, that this study be made part of the larger study of mutual/stock life insurance company issues required by section 231 of DEFRA (due in final form on January 1, 1989), so that the entire insurance company ownership question can be addressed in a comprehensive and systematic fashion.

IV. ALTERNATIVE MINIMUM TAX FOR CORPORATIONS

1. House Bill § 501: The House Bill would institute an alternative minimum tax ("AMT") structure, with an alternative minimum tax rate of 25%. Under the House Bill alternative minimum taxable income ("AMTI") would be computed by adding preference items to regular taxable income, with a general $40,000 exemption; net operating losses, reduced to reflect tax preference items, would be allowed against AMTI. The tax computed thereby would be compared to the regular tax, and the higher amount would be due. The net minimum tax paid (i.e., the excess over regular tax) could be carried forward and used as a credit against regular tax liability in future years. Although the foreign tax credit would be allowed against the minimum tax, incentive tax credits could not be so used. The preference items of particular concern to insurance companies would be those relating to tax-exempt non-essential function bond income and accelerated depreciation.

2. Senate Bill § 1101: The Senate Bill sets out a similar AMT structure, except that the exemption is subject to reduction, and the alternative minimum tax rate is 20%. The preference item with respect to tax exempt non-essential activity bonds would be deleted. A new preference item

of one-half of the excess of adjusted net book income over taxable income would be of major concern to insurers, however.

Under the "book income" preference proposal one-half of the excess of financial statement income over tax income would be included in AMTI as a tax preference. The financial statement used for this purpose would be, in the order of priority, (i) a financial statement filed with the SEC, (ii) an audited financial statement used for credit or other non-tax purposes, (iii) a report to regulatory authorities, or (iv) any other financial statement used for a substantial non-tax purpose. See S. Rep. No. 313, supra, at 530. Book income would be subject to adjustments to reflect various differences between book and tax accounting, such as those that occur when companies are consolidated for financial purposes but not for tax purposes, or when companies use different accounting years for book and tax purposes. The Committee has identified the following as serious problems that arise under the book income proposal:

a. For life insurance companies this preference item raises questions as to which measure of book income would be used. There are also specific problems that arise in connection with the small life insurance company deduction allowed by Code section 806 and the treatment of

intercompany dividends in a non-consolidated life/non-life group of companies.

The first problem arises as a result of the existence of two accepted accounting regimes: generally accepted accounting principles ("GAAP") and the previously mentioned statutory accounting rules. Stock life insurance companies generally file reports with the SEC, and thus must maintain books under both methods, while mutuals typically maintain only SAP books, as they are generally not required to file reports with the SEC. Thus, under the priority rules discussed above, stock and mutual life insurance companies would use different book accounting methods in the determination of this preference item.

The primary differences between GAAP and SAP for life insurance companies concern the treatment of acquisition expenses (deferred under GAAP, expensed under SAP) and reserves (more conservative reserving assumptions are used for SAP than for GAAP).[5] As a general matter SAP income will be equal to or lower than taxable

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[5] Accountants point out that for mutual insurance companies statutory accounting principles are the "generally accepted accounting principles." This report refers to GAAP and SAP to maintain the distinctions discussed above.

income, while GAAP income w ill frequently exceed taxable income.

In the case of mature life insurers the difference between SAP, GAAP and taxable income might not be unduly large. In the case of a smaller, newer stock life insurance company that is rapidly adding new business, the difference can be significant. For example, a growing company that shows SAP and tax losses (based in part on actual cash expenditures, in the form of commissions, premium taxes and other expenses) might show positive GAAP income. Also, the company's GAAP reserves would be somewhat smaller than its tax reserves, and smaller yet than it s statutory reserves, in which case its GAAP income would tend to exceed taxable income. As a result of both of the above factors, the AMTI of a stock company that uses GAAP for book income purposes could be higher than the AMTI of a similarly structured mutual company that uses SAP for book income purposes.

Another concern arises primarily in the case of stock life companies that are small enough to benefit from the small company deduction (up to 60% of tentative life insurance company taxable income of up to $3 mil- lion, subject to a phaseout as taxable income increases from $3 million to $15 million). As this amount is not deductible from book income (either SAP or GAAP), there would be

a difference between tax and book income in this amount. Thus, for example, in the case of a company that has deducted the maximum amount ($1.8 million), $9 million could, in theory, be included in the book income preference item.[6]

Finally, the consolidation rules for life insurance companies give rise to another problem. Companies that are consolidated for tax purposes will be consolidated for book income purposes, while companies that are unconsolidated for tax purposes will be so treated for book income purposes. When affiliated corporations are consolidated, group income and expenses are treated in a unitary fashion, and intercompany dividends are eliminated. When the group is unconsolidated, each member is treated as a separate unit, and intercompany dividends will be included in book income.

The book income treatment of intercompany dividends will possibly cause the AMTI of an unconsolidated group to be higher than that consolidated group.

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[6] It should be noted that where a preference item is due to a timing difference, as is the case for acquisition expenses, alternative minimum tax paid can be carried forward as a credit against the regular tax in subsequent years. The small company deduction constitutes a permanent difference, however, and any associated AMT liability would not be usable as a credit.

This result is probably intended, and may be appropriate in the case of a group that can freely choose consolidation. However, life insurance companies can file consolidated returns with non-life companies only under the restrictive rules of Treas. Reg. §1.1502-47. Thus, many life/non-life groups are unconsolidated, and may therefore be subject to AMT on intercompany dividends even though the group cannot freely elect to consolidate.

b. The impact of the AMT book income proposal on P/C insurers is also significant. First, although the Senate Bill appears to reject the House Bill provision requiring reserve adjustments for fully or partially tax exempt income, the book income preference item seems to subject the P/C company's tax-exempt income to the alternative minimum tax.[7] It should be noted that although the tax-exempt income of all corporate taxpayers will be includible in calculating the book income preference item, this item will be of particular importance to P/C companies, as they typically are heavy purchasers of tax-exempt

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7 The treatment of tax-exempt income results in a permanent difference between tax and book income, and thus any AMT liability cannot be carried forward as a credit. The other items discussed herein would generally be treated as timing differences.

obligations.[8] Second, under statutory accounting principles loss reserves are carried at an undiscounted value, while under GAAP such reserves are discounted to present value. The Senate Bill would also require the discounting of such reserves, but with more conservative assumptions than those used for GAAP purposes. Thus, while as a general matter the book income preference item would never reflect reserve differentials if statutory accounting principles were used, it is possible that the difference between tax reserves and GAAP reserves would constitute a preference item.

Third, it is possible that the treatment of acquisition costs would have a bearing on the book income preference item. Under the regular tax formula set out in the Senate Bill, 20% (or 10% for bond insurers) of a P/C company's unearned premium reserve would be brought into income in order to more properly match policy related income and expenses. As a result of this provision

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[8] For example, in 1981 approximately 47% of P/C companies' investment assets consisted of tax-exempt obligations, and P/C companies purchased more than 20% of all publicly offered tax-exempt securities. See Joint Committee on Taxation, Background on the Tax Treatment of Property and Casualty Insurance Companies 20 (June 13, 1983); General Accounting Office, Congress Should Consider Changing Federal Income Taxation of the Property/ Casualty Insurance Industry 20 (GAO/GCD-85-10), March 25, 1985.

taxable income should always exceed statutory income. However, if the actual acquisition costs exceed 20% (or 10% for bond insurers) of unearned premium reserves, book income determined under GAAP, which requires the amortization of acquisition costs, could exceed tax income in some years.

Finally, an area of concern arises with respect to companies writing certain lines of mortgage and financial guarantee insurance. Under state laws many such companies are required to set aside a certain percentage of earned premium in contingency reserves. Under Code section 832(e) such reserves are deductible for tax purposes if the company purchases special no-interest nontransferable federal bonds, known as tax and loss bonds. The purpose of this arrangement is to allow the company to avoid being taxed on income it must set aside in the contingency reserve, provided the company purchases tax and loss bonds (the economic equivalent of a tax payment) in the amount of the tax benefit of such deduction. Tax and loss bonds are treated as assets for state regulatory purposes.

These contingency reserves are allowed as deductions against income for statutory accounting purposes; they are not, however, accruable under GAAP. Thus, if GAAP is the required book income measure (as it would be for the

typical mortgage or bond insurer, which is a stock company that files reports with the SEC), the deduction for contingency reserves would show up as a book income preference item, despite the absence of a tax benefit, and thus the purchase of the tax and loss bonds would not be treated as a tax payment.

3. Comment: The AMT provisions will be the subject of comments by another committee of the Tax Section. However, the Committee feels the comments in this Report on the application of these provisions to insurance companies are appropriate.

First, it is not clear at this time whether stock insurance companies would be required to use SAP or GAAP for book purposes. As was discussed above, the potential AMT exposure of companies required to use GAAP for book income purposes would generally be higher than that of the companies that use SAP. The obvious problem is the possible creation of a tax-based competitive imbalance between stock and mutual insurance companies. The Committee believes that consideration should be given to whether all insurers should be allowed to use SAP for book income purposes.

Second, we believe that the amount deducted by a mortgage insurer under Code section 832(e), which requires the purchase of the previously described tax and

loss bonds in an amount equal to the tax benefit of the deduction, should be accounted for so that this item is not reflected in the book income preference. One solution is to treat the purchase of the tax and loss bonds as a tax payment.

Finally, it appears inappropriate to subject one or more companies to a higher separate AMT liability, attributable to intercompany dividends, to the extent that the right of such companies to elect consolidation is restricted by law.

V. POLICYHOLDER AND PRODUCT PROVISIONS

A. Exclusion For Interest On Installment Payments of Life Insurance Proceeds

1. House Bill § 1001: The House Bill would repeal the present law exclusion from income of the first $1000 of annual interest paid with respect to installment payments of life insurance proceeds.

2. Senate Bill § 1001: The Senate Bill contains the same provision as the House Bill.

3. Comment: The Committee believes that the repeal, which retains the tax-exempt nature of the life insurance proceeds while-subjecting to tax an amount that would clearly be interest, is appropriate.

B. Deferred Annuity Contracts Held By Other Than Individuals

1. House Bill § 1135: Under the House Bill_the income on the contract of an annuity held by a non natural person would be taxed currently (unless the non natural owner of the contract holds it for the beneficial use of a natural person).

2. Senate Bill § 1234: The Senate Bill contains a provision similar to the House Bill. Further, under the Senate Bill an annuity contract held by an employer on behalf of employees would be treated as an annuity held by a non-natural owner. This rule would not apply when the annuity is held under a qualified plan or as a tax-sheltered annuity or as an IRA.

3. Comment: The Committee takes no position on this provision.

C. Treatment of Corporate-Owned Life Insurance Contracts Under the Alternative Minimum Tax

1. House Bill § 1101: The House Bill AMT proposal would have no impact on corporate-owned life insurance policies.

2. Senate Bill § 1101: The previously discussed book income provision would have the additional effect of currently taxing the increase in cash value

(the "inside build-up") of a corporate-owned life insurance policy, and would also subject to AMT contract benefits paid upon the death of the key employee.

3. Comment: The Committee takes no position on this provision.

D. Special Rule for Annuities

1. House Bill § 1122: This provision would amend the exclusion ratio under Code section 72. Under present law an annuitant may exclude from income the "investment in the contract" (or "basis") with respect to an annuity contract by applying the "exclusion ratio" to each annuity payment made after the annuity starting date. The exclusion ratio is determined by dividing the investment in the contract by the actuarial expectation of total payments. If the annuitant dies earlier than the actuarial table predicts, a portion of basis will be unrecovered; if the annuitant lives longer, a portion of otherwise taxable income is untaxed. The House Bill would correct this result by limiting the exclusion ratio so that no more than actual basis is recovered and by allowing a final return deduction for unrecovered basis.

2. Senate Bill § 1222: The Senate Bill contains a provision similar to the House Bill.

3. Comment: The Committee supports the provision generally. We believe, however, that annuities now in the payout phase should be grandfathered. Extending the new basis recovery rule to annuitized contracts would not only impose an administrative burden on the paying companies, it would subject many older annuitants to unexpected tax liabilities. Thus, we suggest that proposed Code section 72(b)(2) be made effective for annuities with an annuity starting date on or after January 1, 1987.

VI. EXCISE TAX PROVISIONS

1. House Bill § 654: The House Bill contains a provision that would radically change the application of the Federal insurance premiums excise tax ("FET") to reinsurance premiums paid to non-U.S reinsurers. This provision is virtually the same as a Senate amendment that was proposed in the course of the DEFRA legislation, but defeated in conference.

The proposal includes two major prongs. The first would raise the tax on reinsurance premiums to four percent. The second would apply the tax with reference to the country in which the risk ultimately "comes to rest" (i.e., after reinsurance and retrocessions). The IRS would thus collect a tax of four percent of the insurance or reinsurance

premiums attributable to the portion of each U.S. risk which is retained by nonexempt foreign insurers or reinsurer.[9]

2. Senate Bill 955: The Senate Bill deletes the House proposal with respect to the FET, but calls for a study of the effect of various tax treaties on the competitive balance between U.S. and foreign reinsurers.

3. Comment: The Committee believes that the House Bill provision on the FET is unadministrable insofar as it requires tracing of subsequent reinsurances. It appears to the Committee that the House Bill provision should be rejected. We support the proposal to initiate a study of the international reinsurance market.

VII. EFFECTIVE DATES

The House Bill sets an effective date of January 1, 1986, for its provisions of general coverage. There has, however, been a resolution before the House stating the sense of the Members that the effective date of any fundamental tax reform legislation should generally be January 1, 1987. The Senate Bill adopts a general effective date of January 1, 1987. The Committee believes that January 1, 1987 is the appropriate date for all provisions of general application, including the tax rate reductions, to become effective.

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9 Some existing tax treaties such as those with the United Kingdom and France contain excise tax exemptions for premiums paid to treaty country resident insurers. The recently approved treaty with Barbados contains a similar FET exemption, as does the recently negotiated Bermuda treaty.