NATIONAL ALLIANCE OF LIFE COMPANIES

An Association of Life and Health Insurance Companies

DIFFERENTIAL EARNINGS (SECTION 809)

The National Alliance of Life Companies (NALC) is a national trade association of more than 250 life and health insurance companies which do business in all 50 states and the District of Columbia. Smaller insurance companies suffer under the current system of taxation, specifically, the following tax provision.

Equity income is imputed to mutual insurers. Section 809 imposes a formula for identifying the portion of policyholder dividends which allegedly represents the equity return, based on observed differences in the earnings rates between stock and mutual companies. Congress adopted a mathematical formula that imputes additional income to mutual companies based on a comparison of the current one-year average mutual company earnings rate for the previous three years. However, this calculation is based on the earnings rates of a handful of large mutual insurers, with much greater capital and earning power than the smaller to mid-size mutual insurers possess.

The formula under Section 809 operates in two stages: In the first year, mutual companies calculate a differential earnings amount and, in the second year, they calculate a recomputed differential earnings amount. The differential earnings amount is computed by multiplying the "life insurance company's average equity base for the taxable year" by the differential earnings rate (DER) for that year.

The General Accounting Office (GAO) stated in a 1989 study that Section 809 imposes a tax that is regressive both year to year and company by company. When mutual companies do well in a particular year, the average mutual earnings rate is high and the differential earnings rate and resulting taxes are low. When the segment does poorly, the differential taxes are high. When a company does better than the average mutual in a tax year, the differential taxes for that company are a smaller proportion of the total taxes. If the company does worse than average, these taxes are a larger proportion of the total taxes. This results from the way the differential earnings rate, is calculated and applied to all firms, regardless of earnings experience.

In its Final Report to Congress on Life Insurance Company Taxation, The Treasury stated that "different tax rules, such as Section 809, should apply to different forms of business organizations only to the extent necessary to measure accurately and tax equally their net income." Treasury determined that Section 809 is not necessary because "equity returns (of mutual companies) to participating policyholders bear an appropriate tax at the corporate level." Accordingly, Treasury recommended that Section 809 be repealed.

In a 1989 study, the GAO reached a similar conclusion as stated above and also recommended the repeal of Section 809. Indeed, the economist who developed the economic theory on which Section 809 is based, Dr. Henry Aaron of the Brookings Institution, has since concluded that his analysis was incorrect and that Section 809 overtaxes mutual companies.

Finally, smaller to mid-size mutual companies are forced to maintain a higher level of capitalization for rating agency purposes in order to compete with the larger companies. As a result, the smaller companies are penalized by the addition taxation of the surplus, which is charged to earnings and taxed as ordinary earnings. The actual impact on the small to mid-size mutual companies has punitive. In the past few years, the number mutual insurers has been shrinking due to demutualizations and the formation of Mutual Holding Companies. Further, as a result of this activity, the DER has been minimal or nonexistent in recent years.

We believe that Section 809 is bad tax policy. Therefore, we ask that Section 809 be repealed.