May 21, 2012

The Honorable Max S. Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Options for Tax Reform in the Provisions of the Internal Revenue Code Affecting Insurance Companies and their Products

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform in the provisions of the Internal Revenue Code affecting insurance companies and their products. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

William M. Paul
Chair, Section of Taxation

Charles H. Egerton
Last Retiring Chair, Section of Taxation

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
    Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
    Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
    Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
    Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
    Honorable Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
    Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
    Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
OPTIONS FOR TAX REFORM IN THE PROVISIONS OF THE INTERNAL REVENUE CODE AFFECTING INSURANCE COMPANIES AND THEIR PRODUCTS

These options for tax reform (“Options”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

These Options were prepared by individual members of the Insurance Companies Committee of the American Bar Association Section of Taxation. Principal responsibility for preparing these Options was exercised by Craig R. Springfield, Gregory K. Oyler, Peter H. Winslow, Richard R. Belas, John T. Adney, and Tom Quinn. The Options were reviewed by Craig R. Springfield, Committee Chair. The Options were further reviewed by Frederick J. Krull for the Section’s Committee on Government Submissions and by Andrew J. Dubroff, Council Director for the Insurance Companies Committee.

Although the members of the Section of Taxation who participated in preparing these Options have clients who might be affected by the federal income tax principles addressed by these Options, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

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Date: May 21, 2012
I. EXECUTIVE SUMMARY

As discussed in detail below, the following are Options relating to the simplification and reform of the federal tax treatment of insurance companies and insurance products:

• Bond assets of insurance companies could be treated as ordinary to further simplification;
• Restrictions relating to life/nonlife consolidated return filing could be eliminated since they no longer serve a purpose;
• Section 815\(^1\) could be repealed as an obsolete provision; and
• The consumer protection requirements applicable to qualified long-term care insurance contracts under sections 7702B(g) and 4980C and the similar consumer protection requirements of section 101(g) could be restructured solely under the penalty tax regime in order to better protect consumers.

II. OPTION FOR SIMPLIFICATION OF CHARACTER OF INVESTMENT ASSETS OF INSURANCE COMPANIES

A. Option for Consideration

Consideration could be given to treating bonds and other similar evidences of indebtedness held by insurance companies as ordinary assets, so that gain or loss on their sale or exchange would be ordinary income or loss rather than capital. To accomplish this result, a rule similar to section 582(c)(1) (which applies to banking institutions and provides ordinary asset character for bond investment assets) could be added to Subtitle A, Chapter 1, Subchapter L of the Code.

B. Present Law

In general, corporations (including insurance companies) may offset losses from the sale of capital assets only against gains from capital assets.\(^2\) Capital losses that exceed capital gains can be carried back and forward, but on a more limited basis than ordinary net operating losses; capital losses may be carried back only three years and forward only five years.\(^3\) For insurance companies that join in a consolidated return with both life insurance companies and other types of taxpayers, the consolidated return

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to “Regulation section” are to provisions of U.S. Treasury regulations issued under the Code, unless otherwise indicated.

\(^2\) I.R.C. § 1211(a).

\(^3\) I.R.C. § 1212(a).
regulations impose additional complexity for capital losses by requiring a subgroup approach to compute consolidated life/nonlife taxable income, and applying that subgroup approach to capital loss carrybacks.\(^4\) Further, the character of an asset can have significant consequences apart from the limitations on the use of capital losses. For example, under section 1221(b)(2) and Regulation section 1.446-4, tax hedge accounting and ordinary treatment of gain or loss on derivatives used in hedging only apply when the hedging transaction manages risk primarily with respect to ordinary property or ordinary obligations. There is uncertainty under current law as to when the tax hedge accounting rules apply to insurance company “gap hedges” that seek to reduce a duration gap between ordinary liabilities and the capital assets held to fund them.\(^5\)

Similar investment assets of banks, on the other hand, do not give rise to capital gain or loss. Section 582(c) provides that, in the case of “financial institutions,” the sale or exchange of a bond, debenture, note or certificate or other evidence of indebtedness is not considered a sale or exchange of a capital asset. Under current law, an insurance company is not a “financial institution” that qualifies for this ordinary asset treatment.\(^6\)

C. Reasons for Change

1. Bond Investments, and Hedging with Respect to those Investments, Are a Core Business Activity of Insurance Companies

Fundamentally, business operations of insurance companies involve up-front collection of premiums from policyholders, payment over an extended period of obligations under the insurance contracts to policyholders and others, and investment of the premiums in the meantime until payment of the obligations is required. Because many of the liabilities incurred by insurance companies to policyholders are long-term and interest rate-sensitive, a large portion of the investments of insurance companies is in bonds and similar evidences of indebtedness. Because of the nature of the insurance business, investing in bonds exposes insurance companies to a variety of risks, such as the risk that interest rates will change or the risk that the duration of the insurer’s investments will not match the duration of its obligations. Thus, insurance companies manage these and other risks connected with bond investments by engaging in hedging transactions as an essential part of their investment activity. Given the core role of bond investments in an insurance company’s business, income and loss from bond investments and related hedging activity should be treated as part of insurance operating income.

\(^4\) Reg. § 1.1502-47(a).


\(^6\) See I.R.C. § 582(c)(2).
2. Current Treatment of Insurance Companies’ Bond Investments Imposes Significant Tax Compliance Burdens

Complexity in tax compliance for insurance companies in managing their bond investments results from a number of current tax rules, including –

- The rule that capital losses cannot offset ordinary income;\(^7\)
- The rule that capital loss carryover periods are more restrictive than those for ordinary losses;\(^8\)
- The rule under the life/nonlife consolidated return regulations that further restricts use of capital losses;\(^9\) and
- The rule that tax hedge accounting and ordinary treatment generally apply only to hedging for ordinary assets or obligations.\(^10\)

Insurance companies spend significant resources in complying with these rules to avoid inappropriate, adverse tax consequences (e.g., to minimize differences between capital gains and losses, or to prevent realized capital losses from expiring unused after five years). Treating bond investment assets as ordinary assets would significantly reduce these complexities and would reduce the tax compliance burden currently imposed on insurance companies. Reduction of compliance burdens is a proper goal of tax simplification and reform.\(^11\)

3. This Option for Simplification Is Consistent with Principles of Sound Tax Policy

In addition to simplifying tax compliance by insurance companies, the Option is consistent with principles of sound tax policy.

- *The Option Would Provide Ordinary Treatment for a Fundamental Business Activity of Insurance Companies, Consistent with Other Financial Institutions.* Insurance companies’ investments in bonds are part of their core business activity. In providing the ordinary asset rule for banks, Congress acknowledged nearly 70 years ago that the imposition of capital asset

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\(^7\) I.R.C. § 1211(a).

\(^8\) I.R.C. § 1212(a).

\(^9\) Reg. § 1.1502-47(a).

\(^10\) Reg. §§ 1.1221-2(b); 1.446-4.

treatment is not appropriate for entities where the buying and selling of bonds is a fundamental part of the entities’ business. As in the case of banks, bond investment activities are an essential part of the insurance business. Thus, the Option would further Congress’ principle that fundamental business activity should receive ordinary treatment, as well as promote consistent treatment among different types of financial institutions.

In order to ensure that assets are sufficient to satisfy their long-term obligations, insurance companies purchase assets that match, as closely as possible, the interest rates and durations of their obligations. Because of the necessity that the companies’ investments provide sufficient assets to satisfy their long-term obligations, insurance companies, like banks, are unlikely to dispose of investments simply to generate tax losses. In fact, because insurance companies seek to coordinate the durational risks of their investments with those of their obligations, they have less flexibility than other taxpayers to manipulate timing of income or loss solely for tax reasons. In addition, for GAAP reporting purposes, if the securities are designated as “Hold to Maturity,” the sale of the securities to generate losses could taint the portfolio and taint the company’s designation as Hold to Maturity.

• **The Option Enhances Economic Neutrality of the Tax Law.** Under current law, insurance companies try to manage their investment assets so that capital losses do not expire unused. Such tax considerations may cause insurance companies to hold bond assets to avoid generating an unusable capital loss even though it is economically preferable to dispose of the asset. In addition, decisions as to corporate structure may be made to avoid inappropriate restrictions on the use of capital losses in the life/nonlife consolidated return context. The Option would encourage investment decisions for independently worthy economic purposes rather than for purposes of tax reduction, and would thus be consistent with the goal of economic neutrality of the tax law.

• **The Option Eliminates Switching Character of Income on Bond Investments.** The current treatment of interest-yielding investments as capital assets produces mismatches of character between that interest income and gain or loss on the underlying bond. This is especially troubling because fluctuation

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13 Note that an ordinary asset rule is appropriate for insurance companies because investments in bonds are a fundamental part of their business, not simply because they are similar to banks.

14 See Office of the Secretary, Treasury Department, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, at 2 (May 1985). As discussed in part III of this letter, it is also suggested that consideration be given to eliminating the restrictions relating to life/nonlife consolidations.

15 While this is true for all types of taxpayers, it is less appropriate for insurance companies because bond investments are such a fundamental part of their business. Other types of taxpayers do not meet this standard.
in the value of a bond (which gives rise to the gain or loss on the sale) is often a function of changes in how the market perceives that interest stream. For example, credit-related events can result in a drop in bond value; ordinary interest income can accrue even while questions about the collectability of the interest bring a reduction in the value of the bond that would produce a capital loss on its sale. Likewise, changes in market interest rates during the period the insurer holds the bond can result in fluctuation in the bond’s value. In such circumstances, a loss on disposition effectively represents forgone future interest income (when market rates rise), while a gain effectively represents expected future above-market interest income (when rates go down), each of which is embedded in the disposed bond assets. The Option would consistently treat that gain or loss as ordinary in character, the same as the interest income would have been. (A similar matching of character issue exists with respect to the treatment of reserve reductions, which result in ordinary income, and the treatment of dispositions of bond investments maintained to satisfy those reserve obligations, which for proper matching of character also should receive ordinary treatment.)

The Option Allows Efficient Hedging of Core Business Investment Risks. The capital character of insurance companies’ bond investments under current law exacerbates the complexity problems for insurers in hedging with respect to those assets. Because insurers have long-term obligations to make payments under their insurance contracts, investment in bonds presents inherent risks for insurers, and engaging in hedging activities to manage those risks is an essential insurance business activity. A fundamental tax problem stems from the rule that hedges of capital assets do not qualify for tax hedge accounting and ordinary treatment. As a result, an insurer may not use the most efficient hedging strategy because of a concern that the hedge will yield inappropriate or uncertain tax consequences. Artificial tax-driven limitations in business operations may arise, solely due to differences in the tax treatment of capital losses and hedges of capital assets. By providing ordinary treatment of bond investment assets, the Option would result in fewer character mismatches between gains (or losses) on hedging transactions and the hedged assets, clear up controversy about the tax treatment of insurance company gap hedges, and tax hedge accounting would apply so that taxable income is clearly reflected.

D. Additional Considerations

In connection with the Option, it will be necessary to adopt a transition rule to ensure that insurance companies that currently have capital loss carryforwards are not penalized. The new rule will result in insurance companies generating less capital gain than these companies will be able to offset with the capital loss carryforwards. It is important that any adopted proposal be structured to ensure that companies who otherwise would be able to utilize loss carryforwards are still able to do so. One transition option would be to allow pre-existing capital loss carryforwards to offset ordinary gain resulting from sale of bonds.
III. OPTION TO REPEAL CONSOLIDATED RETURN RESTRICTIONS ON CORPORATE GROUPS CONTAINING LIFE INSURANCE COMPANIES

A. Option for Consideration

Allowing the members of an affiliated group of corporations to join in filing a consolidated return prevents the business enterprise’s structure (i.e., its multiple legal entities) from obscuring its true income (or loss) by reflecting the aggregate income (or loss) of all of the members of the affiliated group. Because there is no longer any sound reason to deny affiliated groups of corporations that include life insurance companies the same unrestricted ability to be taxed on consolidated taxable income that is available to other financial intermediaries (and corporations in general), consideration could be given to repealing the restrictions on life-nonlife consolidated returns that are set forth in Subtitle A, Chapter 6, Subchapter A of the Code.

B. Present Law

Members of an affiliated group of corporations generally are permitted to file consolidated returns so that the income of the entire economic unit may be taxed as a whole. The consolidated return provisions represent Congressional acknowledgment that, while an affiliated group of corporations consists of multiple legal entities, it is, in economic reality, a single business enterprise.

Groups that include life insurance companies, however, cannot fully consolidate their income in one tax return. Instead, such groups are subject to certain limits which no longer have a basis in sound tax policy. These restrictions, enacted as part of the Tax Reform Act of 1976 (the “1976 Act”),16 are as follows:

- Life insurance companies must be members of an affiliated group for five years before they may join in a consolidated return with the nonlife members of such group.17
- Nonlife companies must be members of an affiliated group for five years before their losses may be used to offset the life insurance company taxable income of life members of such group.18
- Nonlife losses (including current year losses and any carryover losses) that may offset life insurance company taxable income are limited to the lesser of 35% of life insurance company taxable income or 35% of the nonlife losses.19

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17 I.R.C. § 1504(c)(2).
18 Id.
19 I.R.C. § 1503(c)(1).
C. Reasons for Change

1. Problems Arising from Present Structure

These restrictions place affiliated groups of corporations that include life insurance companies at an economic disadvantage compared with other corporate groups and also create substantial administrative complexities for taxpayers and the Internal Revenue Service (the “Service”). The five-year limitations, in particular, create disparities between groups containing life insurance companies and other consolidated groups. Examples of the complexities caused by the five-year limitations include:

- When a consolidated group acquires a target consolidated group that has a life insurance company member, the target group’s life member is deconsolidated. As a result, unlike for other groups, intercompany gains in the target group involving the life member are taken into account while losses remain deferred.\(^{20}\)

- For the five-year period following a consolidated group’s acquisition of a life insurance company, gains on any intercompany transactions with the life company cannot be deferred. Gains of other groups, which are allowed to file a consolidated return, are allowed to be deferred.\(^{21}\)

- Section 355 spin-off transactions trigger the five-year ineligibility period for a distributed chain of corporations that includes a life insurance company, even if the distributed chain had existed and been filing a consolidated return for many years before the distribution.\(^{22}\)

The 35% limitation acts simply as a rudimentary minimum tax, enacted when life insurance companies were not taxed currently on total income and before the corporate alternative minimum tax was enacted to apply to all corporations.\(^{23}\) Given this purpose, seemingly it should have been repealed as redundant when the tax base of life insurance companies was expanded to total income and the alternative minimum tax was enacted.\(^{24}\)

The ability to file consolidated returns is particularly important for life insurance companies. Many corporations in other industries can, effectively, consolidate the

\(^{20}\) I.R.C. § 267(f); Reg. § 1.1502-13(d).

\(^{21}\) Reg. § 1.1502-13.

\(^{22}\) I.R.C. § 1504(c).

\(^{23}\) At the time of the 1976 Act, life insurance companies were taxed currently on investment income and part of their non-investment income. The report of the Senate Committee on Finance noted that the percentage limitation included in the Senate Committee version of the bill (50%, rather than 35%, as eventually enacted) was included to assure that the tax on life insurance company investment income would continue to be paid. S. Rep. No. 938, 94th Cong., 2d Sess. 454-55 (1976).

returns of affiliates by establishing divisions within one corporation, rather than operating as separate corporations. But state law and other non-tax, business considerations generally require a life insurance company to conduct its nonlife business through subsidiaries. The limitations on joining in a consolidated return thus operate as an economic barrier inhibiting the expansion of life insurance companies into related areas.

As one example, for reasonable business purposes, affiliated groups including life insurance companies have in many instances adopted a structure where the parent company is a holding company. The holding company may incur debt on behalf of the entire affiliated group, but it usually is not an operating company with its own source of income. In other affiliated groups not including a life insurance company, this presents no problem. However, groups with a life insurance affiliate have limitations that prevent full utilization of the holding company’s debt-related and other expenses.25

2. Legislative History and Analysis

With the enactment of the Revenue Act of 1918, life insurance companies were taxed on total income and were allowed to file consolidated returns on the same basis as all other types of companies.26 However, in 1921, legislation was enacted to tax life insurance companies only on their investment income.27 The Revenue Act of 1928 specifically denied the consolidation privilege between insurance companies (including casualty companies) and non-insurance companies beginning in 1929.28 Based on the Revenue Act of 1928, the Service began litigating the consolidation privilege of insurance companies for pre-1929 taxable years.29 The Service was successful, with courts seizing on the Revenue Act of 1928 as a “clarification” of what prior law should have been, and concluding that insurance companies were not subject to the same tax system as were other corporations.30

The Revenue Act of 1932 prevented casualty insurance companies from joining life insurance companies in a consolidated return.31 In explaining why insurance companies could not file with non-insurance companies, the House Report echoed the

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25 I.R.C. § 1503(c).
28 Pub. L. No. 70-562, § 141(e) (1928).
29 See, e.g., Fire Cos. Bldg. Corp. v. Commissioner, 23 B.T.A. 550 (1931), aff’d, 54 F.2d 488 (2d Cir. 1931); Cincinnati Underwriters Agency Co. v. Commissioner, 63 F.2d 309 (6th Cir. 1933) (agreeing with the view of the Second Circuit in Fire Cos. Bldg. Corp.).
incompatibility theory developed earlier by the courts (i.e., that the difference in the method of taxing insurance companies precluded their inclusion in a consolidated return with non-insurance companies). 32

In 1941, however, casualty insurance companies were allowed to consolidate with non-insurance corporations. 33 The House Report again reiterated the general reason for excluding insurance companies from consolidated returns, but concluded that the differences between a casualty company and an ordinary corporation were not so significant as to preclude consolidation. 34

The next major income tax legislation concerning life insurance companies was the Life Insurance Company Income Tax Act of 1959 (the “1959 Act”). 35 Life insurance companies became subject to a complicated three-phase tax system that included current tax on both investment income and a portion of non-investment income. 36 The legislative history contains no record of a review of the consolidated return rules.

Legislative changes following the 1959 Act suggest that Congress may have a more favorable attitude toward the compatibility issue. For instance, in 1964, life insurance companies were treated like ordinary corporations for purposes of the 100% intercompany dividends received deduction. 37 In 1969, losses of various types of insurance companies (including life and casualty companies) were allowed to be carried over if an insurance company shifted from one insurance category to another. 38

There is limited legislative history regarding the consolidated return restrictions on insurance companies as enacted as part of the 1976 Act. 39 In connection with the consideration of this legislation, the Treasury Department agreed that full consolidation is appropriate as a matter of sound tax policy, but was concerned about revenue effects. 40 Also, prior legislation before the Senate Committee would have eliminated all restrictions on the inclusion of life insurance companies in consolidated returns. 41 In order to

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33 Pub. L. No. 77-10, § 7 (1941).
40 Letter from Assistant Secretary of Treasury Charles M. Walker to Senate Finance Committee Chairman Russell B. Long (May 25, 1976).
41 See S. 2985, 94th Cong. (introduced by Senator Abraham Ribicoff (D-CT)). Similar legislation was
accommodate the revenue concerns of the Treasury Department, the Senate Committee reported the legislation with the limitation on loss offset under section 1503(c)(1) at 50% and a delayed effective date to 1978.\textsuperscript{42} In the Conference Committee, however, the House conferees insisted on the five-year rules and cut the loss offset to 35%.\textsuperscript{43} They also insisted that the effective date be delayed for five years.\textsuperscript{44} The Conference Committee report contains no explanation for these restrictions. The Senate Committee observed that the 50% limitation and permissible carryover of unabsorbed losses “preserves the concept sought by Congress in the past to the effect that some tax will be paid with respect to the life insurance company’s investment income (except where the company itself has an overall loss from operations), but at the same time provides substantial relief in the future for casualty companies with losses.”\textsuperscript{45} 

There are two policy explanations for the harsher limitations imposed in conference. First, the five-year rules may have been an attempt to remove a possible threat to competition that could result if strong life insurance companies were to start up new property-casualty affiliates (\textit{i.e.}, to make entry into the property-casualty field less dependent on tax considerations). Second, all of the limitations (the five-year rules, the 35% limitation, and the five-year delayed effective date) could have been intended to ease the short-term revenue effect of allowing consolidation. There is also a reasonable argument that the tougher restrictions may be read as a political compromise that had less to do with sound tax policy than with the personalities of some of the participants.\textsuperscript{46} 

In 1984, changes made by DEFRA subjected all income of a life insurance company to tax, replacing the three-phase tax system of the 1959 Act.\textsuperscript{47} The legislation, however, included a special deduction that effectively provided a lower tax rate for life insurance companies than for other corporations.\textsuperscript{48} The Tax Reform Act of 1986 introduced in the House of Representatives. \textit{See} H.R. 12126, 94th Cong. (introduced by Representative William Cotter (D-CT)).

\textsuperscript{42} S. Rep. No. 938, 94\textsuperscript{th} Cong., 2d Sess. 455-56 (1976).

\textsuperscript{43} H.R. Rep. No. 1515, 94\textsuperscript{th} Cong., 2d Sess. 511 (1976) (Conf. Rep.).

\textsuperscript{44} \textit{Id.}


\textsuperscript{46} The principal sponsor of the original Senate legislation was Senator Abraham Ribicoff (D-CT). Senator Ribicoff offended Chicago Mayor Richard Daley during the 1968 Democratic Convention. The principal proponent of the limitations on consolidation during the conference on the 1976 Act was Congressman Dan Rostenkowski, a protégé of Mayor Daley. A profile of Congressman Rostenkowski published in the October 17, 1993 \textit{Washington Post Magazine} recounted the political background of the dispute and Congressman Rostenkowski’s recollection of how he defeated the proponents of Senator Ribicoff’s provision as political retribution.

\textsuperscript{47} I.R.C. \S 801 (1954), as enacted by DEFRA.

\textsuperscript{48} I.R.C. \S 806 (1954), as enacted by DEFRA.
repealed this special deduction, and life insurance companies were subject to tax on their total income at the general corporate rate.\textsuperscript{49} The TRA 1986 also (i) substantially broadened the tax base of property and casualty companies,\textsuperscript{50} and (ii) modified the section 382 limitations on the use of losses of acquired companies to encompass built-in losses and substantially limit net operating loss carryforwards.\textsuperscript{51}

D. Additional Considerations

The legislative history shows that the restrictions on the ability of life insurance affiliates to file consolidated returns with other nonlife affiliates has been focused on making certain that life insurance companies pay some tax on their income at a time when the tax base of those companies differed significantly from that of other corporations. That disparity in tax base no longer exists.

There is no indication that there was any particular concern about the tax base of other affiliates which could have provided tax losses without incurring economic loss. However, there has been some “conventional wisdom” that, at least in the past, the tax base of property-casualty insurance companies provided that possibility. Of course, if that had been the case, Congress would not have allowed property-casualty companies to be included in consolidated returns with other nonlife insurance companies in the legislation enacted in 1941. Also, after the broadening of the tax base of property-casualty companies provided in the TRA 1986, that argument no longer has validity.

Over the decades, affiliated groups including life insurance companies have undergone different compositions. At one time, there was a focus on multi-line insurance companies with groups including both life and property-casualty companies. At other times, the focus has been on groups with life insurance companies and other financial entities. At still other times, the main problem has been life insurance affiliates under a nonlife parent. However, legislation enacted since the 1976 Act has eliminated material differences between the tax bases of life insurance companies and other corporations, and thus there no longer is a sound tax policy for limiting the ability of such entities to file consolidated returns.

IV. OPTION TO REPEAL SECTION 815 RELATING TO DISTRIBUTIONS TO SHAREHOLDERS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNTS

A. Option for Consideration

Section 815 pertains only to income accruing on and after January 1, 1959, and on or before December 31, 1984, representing a Congressional tool originally designed to


\textsuperscript{50} TRA 1986, §§ 1012 and 1021.

\textsuperscript{51} TRA 1986 § 621 (amending I.R.C. § 382).
balance the tax burden between the stock and mutual segments of the life insurance industry. The provision is now largely deadwood that no longer serves a purpose of any material relevance, and thus consideration could be given to repealing section 815.

**B. Present Law**

From 1921 to 1959, insurance companies were taxed only on their so-called “free” investment income, so that the tax base generally was the excess of earnings from identified portfolio investments over amounts assumed to be needed for current and future policyholder claims. With the enactment of the 1959 Act, insurance companies became subject to tax on their “total income” under a three-phase approach (i.e., income subject to tax included earnings from both investment and underwriting activities, subject to certain adjustments made to allocate the tax burden in an intended manner between the stock and mutual company segments of the industry). In this regard, the Staff of the Joint Committee on Taxation commented that:

The 1959 Act . . . resolved the tension between [the] two industry segments in several ways. It taxed both stocks and mutuals on their free investment income unless it was offset by underwriting losses. With respect to underwriting income, it adopted the nonprofit mutual company as its model, allowing a tax-free distribution of underwriting profits through a deduction for policyholder dividends. To achieve a certain competitive balance within the industry, it reduced the gain from operations tax base for stock companies by allowing certain special deductions for nonparticipating contracts, and accident and health insurance and group life insurance contracts, and by deferring the tax on one-half of underwriting gains.

Because mutuals could reduce or eliminate underwriting profits by paying dividends to policyholders, section 815 provided for a balancing rule in the case of stock companies under which only one-half of net underwriting income would be taxed on a current basis; the other half would be recorded to a policyholders surplus account (“PSA”), which was not taxed until it is deemed to be distributed to the company’s shareholders. The PSA, however, would be treated as distributed only if (a) distributions exceeded a shareholders surplus account (“SSA”) or (b) certain high thresholds were met. The taxable one-half

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52 See Revenue Act of 1921, Pub. L. No. 67-98, § 244 (1921).

53 Staff of the Jt. Comm. On Tax’n, Background on the Taxation of Life Insurance Companies and Their Products, at 7 (JCS-11-83 1983) (emphasis added). See also S. Rep. No. 291, 86th Cong., 1st Sess. 10 at 10 (1959) (discussing the intention of balancing the tax burden in an intended manner between the stock and mutual segments of the industry); Staff of the Jt. Comm. On Tax’n and Senate Comm. on Finance, Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies, at 36-37 (JCS-48-83 1983) (“under the 1959 Act, . . . the relative tax burdens of the mutual and stock segments of the industry effectively are established by means of three special deductions and a provision permitting a life insurance company to defer the tax on one-half of its underwriting gain”) (emphasis added).

54 See I.R.C. § 815(c), (f); I.R.C. § 815(d)(4) prior to DEFRA’s amendments.
of underwriting income constituted “phase II” of the 1959 Act’s three-phase approach, while the remaining half, if and when it became taxable, constituted “phase III” of such approach. (Phase I related to the tax on free investment income.)

C. Reasons for Change

Although section 815 was originally enacted to ensure tax equity among different segments of the life insurance industry under the 1959 Act, it largely became irrelevant with the substantial revision of life insurance company tax rules by DEFRA. When DEFRA was enacted in 1984, the three-phase approach of the 1959 Act was replaced by a single phase approach to tax total income (including underwriting gains), and accruals to the PSA were discontinued (i.e., they were frozen at the then applicable levels and were not required to be brought into income). In commenting on the continued relevance of the PSAs, the Staff of the Joint Committee on Taxation has stated that “[s]ince the limits [for triggering taxation of the PSAs] are so high, and since any distributions to shareholders are deemed to be made first out of taxed income, this portion of the life insurance company tax is of little concern to insurers since it is rarely imposed.” As a practical matter, it is imposed only upon the dissolution or liquidation of an insurance company.

Recognizing the practical obsolescence of section 815, Congress in the American Jobs Creation Act of 2004 amended section 815 so that, for the taxable years of insurance companies beginning after December 31, 2004, and before January 1, 2007, distributions to shareholders would be viewed as first coming from the PSA (rather than from the SSA), but no tax would be assessed on those distributions under section 815. As a result, insurers likely have substantially reduced or eliminated their PSAs. In view of this, and due to the high thresholds that otherwise apply to taxation of PSAs, it is now very unlikely that taxation of material PSA amounts will occur in the future, and the provision is now largely deadwood.

V. OPTION REGARDING CONSUMER PROTECTION REQUIREMENTS FOR QUALIFIED LONG-TERM CARE INSURANCE AND SECTION 101(g) BENEFITS

A. Option for Consideration

Consideration could be given to restructuring the consumer protection requirements of section 7702B(g) relating to the definition of a “qualified long-term care

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55 Pub. L. No. 86-69, § 2 (1959). See also S. Rep. No. 291, supra note 53, at 10 (commenting about the relative tax treatment of stock and mutual companies and posing the question of whether dividends paid to policyholders are properly part of the tax base).


57 Pub. L. No. 108-357, § 705(a) (2004) (enacting I.R.C. § 815(g)).
insurance contract” so that they apply under the penalty tax regime of section 4980C rather than as qualification requirements. Also, consideration could be given to adopting a reasonable cause exception to the penalty tax (e.g., to address circumstances where an insurer’s interpretation of a consumer protection requirement was reasonable, albeit incorrect). Further, if the terms of a contract inadvertently do not comply with the applicable consumer protection requirements, consideration could be given to allowing insurers to offer reasonable corrective action that could be elected at the policyholder’s option to ensure compliance. Where a policyholder chooses not to cure noncompliance with a consumer protection rule that was intended to protect him or her (rather than serve a tax policy role), the offer of a cure under this Option would stop any future accruals of penalties. Similar changes could be considered for the consumer protection rules applicable under section 101(g).

B. Present Law

Under present law, qualified long-term care insurance contracts are subject to various consumer protection rules that are based on the January 1993 version of the National Association of Insurance Commissioners’ Long-Term Care Insurance Model Act and Regulation. Some rules are imposed as qualification requirements by section 7702B(g), while others are imposed as part of the penalty tax rules of section 4980C. Treasury regulations under section 7702B generally defer to state interpretations of such consumer protection rules where the state has adopted the same or a more stringent standard.58

C. Reasons for Change

Numerous interpretive questions are raised by the consumer protection rules which apply to qualified long-term care insurance contracts, especially for combinations of long-term-care insurance with life insurance and annuity contracts. If there is an inadvertent failure to comply with a qualification rule under section 7702B, the consequence is that the contract would not constitute a qualified long-term care insurance contract. In other words, the policyholder will be subjected to less beneficial tax treatment due to an inadvertent failure to comply with a rule which was intended to protect the policyholder (rather than serving a tax policy role) in the first instance. Similar issues apply with respect to the consumer protection rules of section 101(g)(3)(B).

Where a requirement is imposed to protect a policyholder and not to serve a material tax policy purpose, any failure to comply with that requirement by an insurer or other party should not be to the detriment of the policyholder. In order to prevent such an unintended consequence, consideration could be given to restructuring the consumer protection rules of section 7702B(g) under the penalty tax rules of section 4980C. There also is considerable uncertainty regarding the interpretation of various consumer protection requirements, so consideration could be given to (a) allowing a reasonable cause exception to insurers, and (b) allowing reasonable corrective action by insurers

58 See Reg. § 1.7702B-1.
which could be accepted at the option of policyholders. Similar changes could be considered in the context of section 101(g)(3)(B), which applies to certain accelerated death benefits payable from life insurance policies.