The Demise of Sections 809 and 815

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Congress has acted in recent years to remove outdated provisions governing the federal income taxation of life insurance companies from the Internal Revenue Code. In particular, section 809 and section 815 were repealed and suspended, respectively, in 2004.[1] These legislative actions were commendable, as they eliminated two archaic provisions that were based strictly on events and circumstances of the distant past and that did not comport with the present-day reality of how life insurance companies are structured and taxed. This article chronicles the demise of these provisions and explains why Congress was right in removing them from the Code.

The "Segment Balance" Roots of Sections 809 and 815

Code sections 809 and 815 each shared the same fundamental goal—to distribute the overall tax burden of the life insurance industry in a way that would not disturb the competitive "balance" between the stock and mutual "segments" of the industry. These "segments" are based on a historical distinction in the form of business organization within the life insurance industry. Stock life insurance companies have distinct classes of owners and customers, and thus adhere to the general business corporation model. Under that model, the owners of the company (*i.e.*, shareholders) expect to share in the profits generated by the corporation's sale of products or services to customers, and the corporation's distribution of such profits to the shareholders is not deductible by the corporation. On the other hand, distributions to customers solely in their capacity as such, *e.g.*, by way of price rebates, are merely considered reductions in profits and thus are deductible by the corporation. In contrast, mutual life insurers have a single group of persons who are both their owners and customers, *i.e.*, their customers *are* their owners, and, thus, they adhere to the general model for "cooperatives."[2] Under that model, distributions of earnings as "patronage dividends" are deductible by the corporation,[3] and thus are not subject to tax at the level of the cooperative.

This difference in the tax treatment of corporations and cooperatives led Congress to conclude in both 1959 and 1984 that a competitive problem could arise between the stock and mutual segments of the industry depending upon the tax treatment of policyholder dividends.[4] In both 1959 and 1984, mutual companies were dominant in the life insurance industry, which prompted Congress to make adjustments to life insurers' income tax base in an effort to avoid placing tax-based competitive disadvantages upon either segment of the industry. Hence, in developing industry-wide rules for the taxation of life insurers in each of those years, Congress chose one segment of the industry on which to base the rules and established "adjustments" that it deemed necessary to eliminate any competitive

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[1] Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[2] *See* Staffs of the J. Comm. on Tax'n and Senate Comm. on Finance, Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies, at 27 (J. Comm. Print 1983) ("1983 Study") (stating that "[s]tock life insurance companies, like other corporations, have customers (policyholders) and owners (stockholders). Unlike stock companies, mutual life insurance policyholders alone benefit from favorable investment and underwriting experience, since there is no separate group of equity owners").

[3] *See* section 1382.

[4] See 1983 Study, *supra* note 2, at 10 (stating that this "competitive problem is usually discussed in the context of what portion of policyholder dividends should be deductible to a mutual company as a business expense and what portion, if any, is analogous to a stockholder dividend as a return on invested capital to be paid out of after-tax earnings."); S. Rep. No. 86-291, at 10-11 (1959) ("1959 Senate Report") (stating that "the basic question is whether amounts which are distributed back to the policyholders as dividends are properly a part of the life insurance company's tax base," and recognizing that an unlimited deduction for mutual company policyholder dividends could result in a "competitive problem between stock and mutual companies…."). *See also* 50 Cong. Rec. 512-14 (1913) (statements of Rep. Hull, debating the same segment balance point).

advantage or disadvantage that the choice was perceived to place upon the other segment. In 1959, the life insurance company tax rules were based on a mutual company model, and section 815 represented the downward "adjustment" to the tax burden of stock companies that Congress thought necessary to maintain segment balance.[5] In 1984, Congress structured the life insurance company tax rules on a stock company model, and section 809 represented the upward "adjustment" to the tax burden of mutual companies that Congress deemed necessary from a segment balance perspective, and section 815 was kept on the books to ensure Congress' past efforts at segment balance would remain intact.[6]

How Sections 809 and 815 Were Intended to Achieve Their Segment Balance Goals

The Segment Balance Approach in 1984

Because the structure of the life insurance company tax rules was based on a stock company model in 1984, Congress concluded at that time that the policyholder dividend deductions of mutual life insurers should be limited in order to make the portion representing a distribution of corporate earnings nondeductible. Thus, section 809 acted to limit mutual company deductions in this manner. However, because Congress also concluded that there was no accurate method of segregating and measuring the corporate-earnings portion of a dividend payment for each company,[7] it decided to base the limitation on a comparison of the profitability of the mutual and stock segments of the industry.

In doing so, Congress concluded that any difference between the earnings rates of the mutual and stock segments was attributable to the extent that policyholder dividends operated to reduce the mutuals' net income below the profitability they might have had if they had been stock companies.[8] Section 809 attempted to implement this conclusion by reducing a mutual company's dividend deductions by a "differential earnings amount," defined as the product of the company's "average equity base" and a "differential earnings rate." The differential earnings rate, in turn, was determined (by the Internal Revenue Service (the Service)) as the difference between the average earnings rates of the stock and mutual segments of the life insurance industry, after deducting all policyholder dividends.[9]

The Segment Balance Approach in 1959

In contrast to the approach taken in 1984, because the structure of the life insurance company tax rules was based on a mutual company model in 1959, Congress concluded at that time that adjustments should be made to the taxation of stock companies. In this regard, the 1959 Act implemented a complex "three-phase" system of life insurance company taxation under which earnings from both investment and underwriting activities were included in a company's tax base.[10] Under this approach, both mutual and stock life insurance companies incurred an initial tax liability measured by their "total income." However, for the reasons discussed here, that initial liability could be affected substantially by the manner in which policyholder dividends were treated. Rather than dealing with this issue by attempting to differentiate the component parts of a dividend (as was attempted in the 1984 Act), the 1959 Act merely limited deductions in gross. This was accomplished by specifying (in effect) that the deduction of policyholder dividends could not

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[5] *See* Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69 (the "1959 Act"). For a detailed discussion of the 1959 Act, see William B. Harman, Jr., *The Pattern of Life Insurance Company Taxation Under the 1959 Act*, Fifteenth Annual Tulane Tax Institute (1965).

[6] See Deficit Reduction Act of 1984, Pub. L. No. 98-369 (the "1984 Act"). For a detailed discussion of the 1984 Act, see William B. Harman, Jr., *The Structure of Life Insurance Company Taxation—the New Pattern Under the 1984 Act*, Journal of American Society of CLU, March 1985, at 56 (Part I) and May 1985, at 76 (Part II).

[7] *See* S. Prt. No. 98-169, Vol. I, at 549 (1984).

[8] *See id*. This conclusion was based on Congress' assumption that the mutual and stock segments of the life insurance industry have identical earnings rates, and that all profit-oriented enterprises distribute earnings to their owners in proportion to the owners' equity in the enterprise.

[9] In general terms, the earnings differential under section 809 was calculated by comparing (1) the arithmetic average of the stock segment's earnings rates (determined by looking to a sample of the stock companies, *i.e.*, the 50 largest stock company affiliated groups) for the three years preceding the taxable year, with (2) the weighted average earnings rates of all mutual companies for the immediately preceding year (subsequently "trued up" to reflect the mutuals' earnings for the current year). Further, while actual earnings rates were used for the mutual segment in computing this difference, an "imputed earnings rate" was used for the stock segment, an indexing of a 16.5 percent rate chosen to fix the segment balance.

[10] Prior to 1959, life insurance companies were taxed only on their free investment income, leaving their underwriting income free of any tax burden.

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reduce a life insurer's "total income" tax base more than $250,000 below a free investment income floor.[11] Because mutual companies could make use of policyholder dividends to reduce their tax base down to their free investment income under the 1959 Act, underwriting income would be eliminated from their tax base. However, because stock companies typically issued nonparticipating contracts, they generally had no policyholder dividends to deduct, meaning that they could not eliminate their underwriting income from their tax base in this way, or even reduce it to a meaningful extent. In an attempt to address this discrepancy and preclude any perceived competitive disadvantages it could cause within the industry, Congress enacted a variety of segment balance provisions, including section 815.[12]

In this regard, the 1959 Act taxed one-half of a company's net underwriting income on a current basis. According to section 815, the other half was to be recorded in a memorandum account known as the "policyholders surplus account" (PSA). The untaxed half of the stock company's net underwriting income was not to be subjected to tax until (and unless) section 815 treated it as distributed to the company's shareholders. Because amounts were deemed to be distributed from a company's PSA (1) only after actual (or deemed) distributions to the shareholders exceeded the totals in the "shareholders surplus account" maintained by the company,[13] or alternatively (2) only after certain intentionally high thresholds were exceeded,[14] the reality was that amounts typically would be treated as coming out of a PSA only upon dissolution or liquidation of the company.

The three-phase system of life insurance taxation remained in effect until 1984, when Congress replaced it with a single-phase approach that applies today. Under the 1984 Act, further PSA accumulations were discontinued, and underwriting income became fully taxable to both stock and mutual companies in the year it was earned. Significantly, the amounts in the PSAs were "frozen;" they were not brought into taxable income, but merely were allowed to enjoy the *status quo*. Also, to preserve that *status quo* (*i.e.*, non-taxation of the PSA amounts), the 1984 Act directed that the shareholders surplus accounts and the elements comprising the other thresholds generally should continue to grow as before.[15]

Criticisms of Sections 809 and 815

The most compelling criticism of sections 809 and 815 has been one that applies equally to both, namely, that they were outdated provisions based strictly on events and circumstances of the distant past that did not comport with the present-day reality of how life insurance companies are structured and taxed.[16] Unlike the circumstances in 1959 and 1984 when sections 815 and 809 were enacted, mutual companies no longer represent the dominant segment of the life insurance

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[11] Congress determined that mutual companies, which at the time accounted for approximately 63 percent of the life insurance in force and 75 percent of the total assets in the life insurance industry, would carry an appropriate portion (69 percent) of the industry's total tax burden under the then-new regime, clearly indicating that the limitations on policyholder dividend deductions of mutual companies were aimed at achieving segment balance. *See* 1959 Senate Report, *supra* note 4, at 10.

[12] In the words of the Staffs of the Joint Committee on Taxation and the Senate Finance Committee in their 1983 pamphlet, "[u]nder the 1959 Act, the differences between mutual companies and stock companies are taken into account, and 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*." 1983 Study, *supra* note 2, at 36-37 (emphasis added).

[13] *See* section 815(b) and 1959 Code section 815(a)(1). The shareholders surplus account is a tax-paid account consisting of taxable income and (to the extent not included in taxable income) long-term capital gains, together with certain intentionally untaxed amounts. *See* section 815(c) and 1959 Code section 815(b)(2)(A)(i), (ii), (iii), and (iv).

[14] In general, these thresholds were (A) 15 percent of life insurance reserves at the year end; (B) 25 percent of the excess of life insurance reserves at year end over such reserves at the end of 1958; or (C) 50 percent of the net amount of premiums and other consideration taken into account for the year under 1959 Code section 809(c)(1) (defining premiums for purposes of calculating "gain from operations").

[15] *See* section 815(c), (f).

[16] *See* William B. Harman, Jr., John T. Adney, and Bryan W. Keene, *The Taxes on Starlight: The Case for the Repeal of Sections 809, 815, and 1503(c) of the Internal Revenue Code*, 20 Ins. Tax Review 31 (January 2001).

industry.[17] Moreover, the enactment of the Gramm-Leach-Bliley Act of 1999[18] modernized the rules of competition and affiliation within the entire financial services industry. This modernization has caused a significant movement of assets and companies from the mutual to the stock segment of the industry through demutualizations and the creation of mutual holding companies with stock subsidiaries. As a result of these changes in the life insurance industry, an approach to taxation that looks solely to one part of that overall industry is clearly inappropriate and antiquated. Consequently, the segment balance provisions embodied in sections 809 and 815 could not serve to ensure tax equity between segments of the life insurance industry, but instead served to create uncertainty and to hinder the industry's ability to function in an increasingly global financial services marketplace. These factors, along with the fact that neither section has been a source of significant tax revenue for the federal government, ultimately led to their repeal and suspension.

The Repeal and Suspension of Sections 809 and 815

In 2002, Congress began to recognize that the segment balance functions served by sections 809 and 815 were no longer needed or appropriate due to significant changes in the organization and taxation of the life insurance industry. Hence, it passed the Job Creation and Worker Assistance Act of 2002, which suspended section 809 for taxable years beginning in 2001, 2002 and 2003.[19] Two years later, Congress passed the Pension Funding Equity Act of 2004, which repealed section 809 effective for taxable years after December 31, 2004, leaving 2004 as the only year since 2001 that section 809 was operative. However, the Service subsequently issued guidance indicating that the differential earnings rate and the recomputed differential earnings rate for 2004 were both zero, thereby eliminating any remaining impact of section 809.[20] We can all be thankful that a code provision that deeply divided the industry for many years, both in its enactment and in its operation, and, ironically, raised significant revenue in only four of the years from 1984 through 2004, is now a historical anomaly.

In the same year that section 809 was repealed, Congress passed the American Jobs Creation Act of 2004.[21] A provision of the new law added subsection (g) to section 815 for taxable years beginning after December 31, 2004, and before January 1, 2007, pursuant to which distributions to shareholders from PSAs are treated as zero and providing that any distributions to shareholders during these years are treated as first coming from a company's PSA, then from its shareholders surplus account, then other accounts. These provisions effectively repealed section 815, since they allow stock companies to eliminate their PSA balances during the two-year suspension period.

The fact that section 809 was repealed and section 815 was effectively repealed in the same year reveals that the fundamental reason for taking these actions was a determination by Congress that the provisions were antiquated and no longer served any legitimate purpose. It is a worthwhile goal to remove provisions from the Code once they become outdated relics with no modern rationale to support their continued existence. Many in the industry have argued that there are other Code provisions that share this fundamental flaw, such as the current-law restrictions that limit a life insurance company's ability to file a consolidated federal income tax return with its non-life insurance company affiliates, and limit the use of losses of these non-life insurance entities against income of life insurance company affiliates. Will Congress turn to these provisions next?

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17 In 2003, stock life insurance companies held approximately 81 percent of industry assets, compared to approximately 16 percent for mutual companies. In that year, stock companies also accounted for approximately 91 percent of the total number of life insurers doing business in the United States (compared to approximately 8 percent for mutual companies) and approximately 84 percent of the life insurance in force (compared to approximately 10 percent for mutual companies). The figures for mutual companies include stock companies owned by mutual holding companies. AMERICAN COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2-3 (2004). Compare the figures discussed in note 11, *supra*.

18 Pub. L. No. 106-102.

19 Pub. L. No. 107-147. Technically, the act treated the differential earnings amount and the recomputed differential earnings amount as zero for these years.

20 *See* Notice 2005-18, 2005-9 I.R.B. 634, and Revenue Ruling 2005-58, 2005-36 I.R.B. 465 (regarding the differential earnings rate); Notice 2006-18, 2006-8 I.R.B. 502 (regarding the recomputed differential earnings rate).

21 Pub. L. No. 108-357. A Senate amendment to the bill that became the American Jobs Creation Act would have repealed section 809 for the 2004 tax year, but it was not included in the conference agreement.