Report to The Congress on Fraternal Benefit Societies

Chapter 1

Department of the Treasury
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INTRODUCTION AND SUMMARY

BACKGROUND

A Treasury Department Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth (Treasury I), included a proposal to repeal the tax exemption for certain insurance companies and impose tax on the insurance income of fraternal benefit societies.[1] This proposal was not included in the Tax Reform Act of 1986 (TRA) (Public Law 99-514). However, section 1012(c) of TRA[2] required the Treasury to study certain fraternal benefit societies that benefit from tax exemption under section 501(c)(8) of the Internal Revenue Code of 1986.[3]

The purpose of this study is to examine the operations and to assess the taxation of the insurance income of these fraternal benefit societies. Fraternal benefit societies provide insurance and other benefits for members, charitable goods and services for the community, and fraternal or club services for members. Similar to other tax-exempt organizations, fraternal benefit societies are taxed on income from business that is unrelated to the organization's exempt purpose (unrelated business income). However, insurance income is not treated as unrelated business income. This treatment of insurance income differs from the treatment of insurance income earned by other tax-exempt organizations and commercial insurers, both of which are taxed on their life, and property and casualty insurance business income.[4]

As discussed in the General Explanation of the Tax Reform Act,[5] Congress was interested in the determination of whether fraternal benefit societies were engaged in large-scale insurance activities, the nature and scope of which were inherently commercial rather than charitable. Under such circumstances, tax exemption of their insurance income may be inappropriate. Therefore, Congress requested Treasury to obtain information regarding use of untaxed revenues from insurance activities of these organizations.

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[1] U.S. Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth, Report to the President, [Treasury 1] U.S. Govt. Print. Off. (November 1984), at pp. 286-287.

[2] The due date for this study was extended from January 1, 1988, to July 1, 1992 by section 11831 of the Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508). See Appendix 1 for a copy of the Congressional mandate for this report and the extension of the due date.

[3] Unless otherwise indicated, all "section" references refer to the Internal Revenue Code of 1986.

[4] In 1985, the commercial life insurance industry paid $2.9 billion of income tax after credits on $7.4 billion of taxable income while mutual life insurance companies paid $1.3 billion of tax on $3.4 billion of income according to the U.S. Department of the Treasury, Interim Report to Congress on Life Insurance Company Taxation, (June 1988), p. 14.

[5] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, U.S. Govt. Print. Off. (May 4, 1987), at pp. 584-586.

As a result of Congress' request, Treasury conducted a study which examines the economic rationale for tax exemption and assesses whether it justifies tax exemption for the activities of fraternal benefit societies. The study also assessed four potential uses of funds from the tax exemption on insurance income: (1) whether the tax exemption for insurance income is financing charitable and fraternal activities; (2) whether the fraternal benefit societies are rebating the tax exemption to their policyholders in the form of lower prices for life insurance; (3) whether the exemption is in essence subsidizing less efficient insurance operations than those of comparable commercial insurers; and (4) whether the tax exemption has been used by fraternal benefit societies to accumulate surplus in excess of that accumulated by comparable commercial insurers.

To analyze these issues, Treasury gathered data on seven fraternal benefit societies which met Congress' stated study parameters.[6] A special survey was conducted to collect information on receipts, expenses, and operation for each of these fraternal benefit societies. This information was supplemented with publicly available data.

PRINCIPAL FINDINGS

- The insurance activities of fraternal benefit societies are income-producing activities that are similar in nature and scope to that provided by taxable commercial insurers. While there are some distinctions, the insurance policies of fraternal benefit societies appear to serve the same markets as those served by commercial insurers.

- The benefits to society from charitable services, the redistributive nature of some fraternal services, and the use of the conduit organization form for providing fraternal services may justify continuation of tax exemption for these activities of fraternal benefit societies.

- A major economic argument for exempting an organization from income tax is that absent the tax exemption, the quantity or quality of a good or service produced by the organization would be lower than is desirable for society. Generally, economic analysis has concluded that the provision of life insurance is not a good or service that confers significant benefits to society as a whole. In this regard, the insurance activity of the fraternal benefit societies, by itself, does not appear to be distinctive from the insurance activity of commercial insurers so as to be excluded from this general economic view.

- Analysis of the cost of comparable insurance policies indicates that fraternal benefit societies charge prices similar to those charged by large mutual life insurance companies. These prices are sufficient to cover costs (including taxes paid by commercial companies) and suggest that the tax exemption provided to the fraternal benefit societies is generally not being passed onto policyholders in the form of lower prices for insurance. Fraternal benefit societies do not appear to compete unfairly with taxable insurance companies.

[6] Fraternal benefit societies that received gross annual insurance premiums in excess of $25 million in 1984 were to be studied.

- Analysis of certain measures of operating efficiency indicate that fraternal benefit societies operate as efficiently as large mutual life insurers, and that their tax exemption is not being used to finance inefficient operations.

- Comparison of the rate of surplus accumulation and level of accumulated surplus of fraternal benefit societies with that of large mutual life insurers suggests that some of the tax exemption is financing additions to accumulated surplus. The comparison recognizes that mutual life insurance companies also accumulate surplus, but the study generally finds that the rate of surplus accumulation and amount of surplus accumulated are significantly greater for the tax-exempt fraternal benefit societies.

- Fraternal benefit societies provide many charitable services; however, much of the combined fraternal and charitable activity appears to be more fraternal in nature. A major proportion of the combined expenses are for non-contract benefits to members (insurance-type benefits, such as adoption and burial expenses), as well as support of more social activities. Charitable expenditures benefiting non-members (traditional tax-exempt organization activity) appear to be less prevalent than expenditures for the fraternal activities.

POLICY OPTIONS

The Congress may wish to consider the following options relating to the tax treatment of fraternal benefit societies:

<u>No Change in Current Tax Treatment</u>

Fraternal benefit societies perform valuable social, commercial, and charitable functions. The charitable services provided by fraternal benefit societies benefit society as a whole. Fewer of these charitable goods and services are likely to be provided unless current tax treatment continues. The economic distortions caused by the special treatment of fraternal benefit societies are relatively minor in comparison to other policy priorities. Thus, Congress could decide not to change the fraternal benefit societies' current tax treatment.

<u>Modify Tax Treatment of Fraternal Benefit Societies</u>

If Congress decides to modify the tax treatment of the insurance activities of fraternal benefit societies, it may be appropriate for a fraternal benefit society that continues to have insurance activities which are a substantial part of its business, to be taxed as a mutual life insurance company. If a fraternal benefit society has only minor insurance activities, then the fraternal benefit society could be allowed a choice of being subject to section 501(m) and paying UBIT on insurance income or converting to a section 501(c)(10) domestic fraternal society and being prohibited from selling insurance. Because of the administrative burdens of being subject to taxation, modification of tax treatment could be limited to only large fraternal benefit societies that do not subsidize insurance for low-income members. In recognition that the fraternal benefit societies incur large charitable expenses, consideration could be given to increasing (or raising) the limitation on deductible charitable contributions for these entities, which is presently 10 percent of taxable income, or permitting a deduction for a portion of their combined charitable and fraternal expenses. Permitting the latter allows the fraternal benefit society to provide such services while limiting their compliance costs and the Internal Revenue Service's administrative costs.

ORGANIZATION OF THE REPORT

The study describes the special exemption for fraternal benefit societies and the rationale for such treatment. This perspective is followed by an overview of the current operations of the surveyed fraternal benefit societies. The study then presents data and analysis of the insurance activities of fraternal benefit societies and their commercial counterparts and a description and analysis of the funding of fraternal and charitable activities. Finally, the study presents a summary and policy options.