

## Tax on Insurance Buildup

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Under current law, earnings from an investment in a life insurance contract are exempt from tax. The proposal would tax the investor annually on the internal earnings on the life insurance policy, including earnings to pay for insurance coverage. Life insurance companies would be required to report and withhold tax on the increase in cash surrender value plus the cost of the insurance, less the premiums paid. Actuarial gain — the outcome of a bet without any time value or earnings element — would continue to be tax exempt, however.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at <http://www.taxshelf.org>. A longer description of the Shelf Project can be found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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Life insurance contracts often combine a savings or investment element with pure insurance protection that covers the risk of death during the year. Current law will tax the buildup in the value of a "life insurance contract" only if the policy is surrendered for its cash value during life. If the contract stays within the limits of a qualified insurance contract, the investment earnings paid out by reason of death of the insured are tax exempt.

The proposal would tax the earnings on the insurance contract in all cases as it occurs, even if the transaction qualifies under the limitations of "life insurance contract" under current law. Life insurance competes with other investment vehicles in the marketplace and there is no justification for taxing investment returns accomplished through a life insurance company more generously than any other vehicle, especially in times of revenue need. Life insurance that gives a guaranteed interest rate on principal is like interest on a bank account and is proposed to be taxed accordingly. However, for life insurance that specifies an investment return that depends on changes in the value of a separate fund comparable to a mutual fund (such as variable life insurance), the investment returns would be taxed in the same manner as investments in mutual funds.

Under the proposal, actuarial gain — that is, the outcome of a bet without any earnings element — would continue to be tax exempt. The IRS would collect tax on actuarial gain by taxing income used to pay the premiums put into the actuarial pool, and it would not further tax the policy payouts on the death of the insured.

### A. Current Law

In general, payments received under a life insurance policy by reason of the death of the insured are not taxed.<sup>1</sup> Life insurance contracts are often investments, and the exemption covers earnings from that investment. If, however, the transaction has investment features beyond the limitations in section 7702 for "life insurance contracts," the investor pays ordinary tax currently on the increase in the cash surrender value of the policy, plus the cost of insurance coverage for the period less the premiums paid.<sup>2</sup>

The exemption for life insurance also does not apply if the beneficiary buys an existing policy for valuable consideration.<sup>3</sup> The exemption does not apply to interest earned on the life insurance proceeds after the insured's death.<sup>4</sup> Cash withdrawals from a policy before the insured's death are generally taxed as ordinary income at the time of withdrawal to the extent the amount withdrawn exceeds the investment in the contract.<sup>5</sup> However,

<sup>1</sup>Section 101(a).

<sup>2</sup>Section 7702(g).

<sup>3</sup>Section 101(a)(2) and (a)(2)(A). Further exception to inclusion is provided for transfers between the insured and a partnership in which the insured is a partner or between the insured and another partner. Also excepted are transfers between the insured and a corporation in which the insured is an officer or shareholder. Section 101(a)(2)(B).

<sup>4</sup>Section 101(d).

<sup>5</sup>Section 72(e)(5)(C). If section 7702A characterizes the contract as a "modified endowment contract," withdrawals from a policy before the insured's death are taxed as ordinary income

(Footnote continued on next page.)

payments to a chronically or terminally ill insured are tax exempt; they are treated as if they were payments after death.<sup>6</sup>

In economic terms, payments from life insurance come from two sources: actuarial gain and investment earnings. Actuarial gain reflects pure insurance whereby the premiums from many insureds cover the proceeds paid out. Premiums are contributed into the actuarial pool depending in amount on the insureds' risk of death during the year, and the pool is distributed to the beneficiaries of insureds who die. For example, assume that a 45-year-old buys a \$1 million policy to provide financial resources to his dependents to replace his income in the event of death. According to national statistics, a 45-year-old white male has about a 1-in-286 (or 0.35 percent) chance of dying within a year.<sup>7</sup> Given the 0.35 percent likelihood of that insured's death, the expected value of his beneficiaries receiving \$1 million should he die during the year equals \$3,500. A life insurance company could cover the likelihood of paying out the \$1 million during the current year (but not the transaction costs or its profits) by collecting \$3,500 each from 286 insureds of the same age and gender. The insurance company would receive just over \$1 million in premiums, which it would pay to the beneficiaries of the one expected decedent.

In a "term" life insurance policy, the policy proceeds that beneficiaries receive are almost entirely actuarial gain. The proceeds are paid out shortly after the premiums are paid in, and the insurance company has not had time to make significant earnings from investment of the premiums. Term life insurance is similar to fire or car insurance in that the policy has no residual (or cash) value once the term year covered by the premium has passed. Because the insured's risk of dying during the term year increases as he ages, the necessary premium for coverage under term life insurance rises over time.

The second economic element of a life insurance policy comes from investment earnings, which the insurance company is able to make from investing the premiums. When the current premium payment and earnings from the premiums exceed the necessary contribution to the actuarial pool, the insurance company has a fund it can invest. The investment and earnings can be used to pay the necessary contribution to the actuarial pool for insurance coverage in future years. The insurance company also credits to the insured's policy earnings in excess of the actuarial cost of providing insurance coverage, and it allows the insured to withdraw the net value of the fund as a cash surrender value. The cash surrender value will be equal to premiums and earnings from the premiums, less expenses that the insurance company charges and less the necessary contributions to the actu-

arial pool insurance coverage for the time that has passed. A life insurance policy with an investment element combines a savings account with a bet — for a 45-year-old male, a 1-in-286 bet.

Life insurance companies market different types of life insurance policies that incorporate different degrees of investment. The traditional form of insurance is the "whole life insurance" or "ordinary life insurance," which requires a fixed premium payment each year over the life of the insured, even though the cost of insurance coverage necessarily increases as the insured ages and mortality risk rises. Table 1, on the next page, illustrates the logic of that type of life insurance by considering the first 20 years of a \$1 million policy on a 45-year-old white male. In each year described in Table 1 that the policy is in effect, the fixed annual premium (column 4) exceeds the actuarial cost of the life insurance protection (column 3). As the cash value builds, the investment return helps to pay some of the annual cost of life insurance protection and then builds up the cash surrender value of the policy. At age 51 and each year thereafter, the earnings from the investment exceed the amount needed to pay for insurance coverage. As shown in column 2, less and less of the \$1 million payout needs to be funded from the actuarial pool and more will be funded by the cash surrender value. A policy "matures" when its cash surrender value has grown large enough to satisfy the full payout of the policy without any insurance element. The policy in the example matures at age 78 (beyond the years shown in Table 1). The illustration also simplifies real insurance because it does not cover transaction costs or the insurance company's profit.

Life insurance companies also market other forms of life insurance with a greater degree of investment orientation. For example, the same 45-year-old white male could purchase a "single premium" \$1 million policy that matures at age 78 by paying one premium of approximately \$272,000. Assuming that the earnings from the investment were equal to 5 percent each year, the investment income would be more than twice the actuarial cost of life insurance protection each year.

Enacted in 1984, section 7702 allows the exclusion of earnings on the buildup in life insurance only if the policy has no more investment characteristics than were available under life insurance commonly marketed at that time. Under section 7702, a "life insurance contract" that continues to be eligible for the exclusion must satisfy either a cash value accumulation limitation (section 7702(b)) or a limitation that reflects both premiums paid and accumulations of cash value (section 7702(c)). The limitations are sometimes meaningful but not very restrictive.<sup>8</sup> Contracts complying with those limitations may reflect very different insurance protection and investment elements. In addition to the traditional "ordinary" life insurance policy design illustrated in Table 1, section 7702 permits the use of a "single premium" design in which only one very large premium is paid

at the time of withdrawal to the extent that the cash surrender value exceeds the investment in the contract.

<sup>6</sup>Section 101(g).

<sup>7</sup>Table 103. *Expectation of Life and Expected Deaths by Race, Sex, and Age*, 2005, U.S. Census Bureau, Statistical Abstract of the United States: 2009, available at <http://www.census.gov/compendia/statab/tables/09s0103.pdf>.

<sup>8</sup>See Andrew Pike, "Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance," 43 *Tax L. Rev.* 491, 506-522 (1988).

Table 1. Ordinary Life Insurance for \$1 Million Coverage (5% growth)<sup>a</sup>

Age	1. Mortality Risk	2. Payout Needed From Pool	3. Cost of Insurance Coverage (col. 1 x col. 2)	4. Constant Premium (Derived Figure)	5. Add to Cash Surrender (col. 4 less col. 3)	6. Cash Surrender Value (prior col. 8 + col. 5)	7. Earning on col. 6 at 5%	8. Cash Surrender Value w/ Earnings (col. 6 + col. 7)
45	0.0035	\$1,000,000	\$3,500	\$17,816	\$14,316	\$14,316	\$716	\$15,032
46	0.0038	\$984,968	\$3,733	\$17,816	\$14,083	\$29,114	\$1,456	\$30,570
47	0.0041	\$969,430	\$3,975	\$17,816	\$13,841	\$44,411	\$2,221	\$46,632
48	0.00445	\$953,368	\$4,242	\$17,816	\$13,573	\$60,205	\$3,010	\$63,215
49	0.00484	\$936,785	\$4,534	\$17,816	\$13,282	\$76,497	\$3,825	\$80,322
50	0.00527	\$919,678	\$4,847	\$17,816	\$12,969	\$93,291	\$4,665	\$97,956
51	0.00573	\$902,044	\$5,169	\$17,816	\$12,647	\$110,603	\$5,530	\$116,133
52	0.00619	\$883,867	\$5,471	\$17,816	\$12,345	\$128,478	\$6,424	\$134,901
53	0.00662	\$865,099	\$5,727	\$17,816	\$12,089	\$146,990	\$7,350	\$154,340
54	0.00705	\$845,660	\$5,962	\$17,816	\$11,854	\$166,194	\$8,310	\$174,503
55	0.00748	\$825,497	\$6,175	\$17,816	\$11,641	\$186,144	\$9,307	\$195,452
56	0.00796	\$804,548	\$6,404	\$17,816	\$11,412	\$206,863	\$10,343	\$217,206
57	0.00852	\$782,794	\$6,669	\$17,816	\$11,146	\$228,353	\$11,418	\$239,770
58	0.00923	\$760,230	\$7,017	\$17,816	\$10,799	\$250,569	\$12,528	\$263,098
59	0.01011	\$736,902	\$7,450	\$17,816	\$10,366	\$273,464	\$13,673	\$287,137
60	0.01116	\$712,863	\$7,956	\$17,816	\$9,860	\$296,997	\$14,850	\$311,847
61	0.01232	\$688,153	\$8,478	\$17,816	\$9,338	\$321,185	\$16,059	\$337,244
62	0.01352	\$662,756	\$8,960	\$17,816	\$8,855	\$346,099	\$17,305	\$363,404
63	0.01465	\$636,596	\$9,326	\$17,816	\$8,490	\$371,894	\$18,595	\$390,488
64	0.01572	\$609,512	\$9,582	\$17,816	\$8,234	\$398,723	\$19,936	\$418,659
65	0.01687	\$581,341	\$9,807	\$17,816	\$8,009	\$426,667	\$21,333	\$448,001

<sup>a</sup>The constant premium (column 4) to reach maturity at age 78 was derived using the goal-seek function of an Excel spreadsheet program, which finds the result by iteration (aka, trial and error). Mortality risk is from the U.S. Census Bureau, *Table 103. Expectation of Life and Expected Death*, *supra* note 7.

when the policy is issued. Section 7702 also sanctions more flexible arrangements, such as variable life insurance and universal life insurance, which incorporate both investment and premium payment flexibility. Because the limitations were written to protect almost all life insurance products marketed during the early 1980s, just before the bill was enacted, they reflect neither fundamental principles of economic theory nor tax policy. Moreover, the section 7702 limitations are complex and depend on actuarial concepts and calculations exclusive to the insurance industry.

**1. Interest costs of insurance.** The tax exemption for investment earnings received by the beneficiary of an insured individual suggests that any cost (including any interest expense attributable to the payment of the insurance premium) should be matched with the earnings. Since the earnings are tax exempt, no deduction should be allowed for those expenses.<sup>9</sup> Allowing taxpayers to deduct the costs of the policy while exempting the policy

<sup>9</sup>Deduction is indeed disallowed for any premiums paid by the beneficiary of a life insurance policy. Section 264(a)(1).

proceeds from taxation creates tax sheltering deductions that can shield unrelated income from tax.

Courts have often been able to recognize that insurance financed by the insurance company itself involves no change of economic substance, and they have disallowed the interest deduction. In *Knetsch v. United States*, the Supreme Court ruled that insurance funded by company-provided nonrecourse loans was a sham as a matter of law because the loans and insurance meant that there was no change in the beneficial interest of the insured investor, except for tax.<sup>10</sup> Three circuit courts of appeals recently applied *Knetsch* to corporate-owned life insurance “cost” offset by borrowing from the policy;<sup>11</sup> however, the scope of the economic substance

<sup>10</sup>364 U.S. 361 (1960). *Accord*, LTR 9812005 (Mar. 20, 1998), Doc 98-9945, 98 TNT 55-12.

<sup>11</sup>*Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp.2d 748 (E.D. Mich. 2003), *cert. denied* 127 S. Ct. 1251 (2007); *American Electric Power Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003), Doc 2003-10647, 2003 TNT 82-11; *IRS v. CM Holdings Inc. (In re CM Holdings Inc.)*, 301 F.3d 96 (3d Cir. 2002), Doc 2002-19191, 2002 TNT 161-10; *Winn-Dixie Stores Inc. v.*

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## COMMENTARY / SHELF PROJECT

doctrine remains contested in litigation.<sup>12</sup> If the *Knetsch* economic substance doctrine applies, interest on the loans is not deductible.

There are also important statutory restrictions on the deduction of interest costs of life insurance. No interest is allowed if the policyholder contemplates systematic direct or indirect borrowing of the increases in cash surrender value. If such borrowing is not contemplated, the corporation may deduct normal levels of interest incurred on debt only for life insurance on its key persons, for debt of up to \$50,000 per key person and for 20 key persons.<sup>13</sup> The exemption for earnings on those plans, sometimes called “janitor insurance,” remains available.

Life insurance companies receive deductions for reserves to pay future claims. (Outside insurance companies, “reserves” are ordinarily not deductible.)<sup>14</sup> The function of the reserves is to ensure that earnings the life insurance company has committed to the insureds are not taxable to the company.<sup>15</sup> Neither the company nor the insured pay tax on the earnings buildup paid out by reason of death.

If the holder gets a distribution of cash surrender value from a life insurance policy during life, the holder is taxed only to the extent that the amount received exceeds the aggregate amount of premiums paid on the contract.<sup>16</sup> In general, amounts used to pay for life insurance protection represent personal expenses of the contract holder. An owner of a checking account who directs the bank to pay a personal expense such as life insurance from the account must reduce the account’s adjusted basis. The recovery of the full amount of premium payments, without reduction for the cost of annual life insurance protection, against distributions during life is thus an anomaly.

### B. Reasons for Change

A tax does the least harm if it is a comprehensive tax. Putting all economic gains into the tax base allows the tax rates to be as low as possible for any given level of

government spending. Lowering the tax rates reduces the harm that tax does to private arrangements. Investment vehicles need to compete with each other on the basis of their nontax characteristics rather than their tax advantages. Subsidies for any form of investment that privilege that form over rival forms need to be accomplished by a budgeted government expenditure. That is because government is rational in its use of limited resources only through a competitive federal budget; Congress thinks of subsidies as real money only when they entail direct government spending.

Consistent with the premise that the tax treatment of life insurance should not be a subsidy, the proposal would exempt actuarial gains from life insurance but would tax earnings from investment, even if accomplished in connection with life insurance.

**1. Actuarial gain.** The proposal would exempt actuarial gains from taxation. The exemption can be justified within an income tax as long as premiums are not deductible. Because premium payments are not deductible<sup>17</sup> and are thus made “after tax,” the IRS collects tax on the actuarial gains by taxing the pool of premiums for insurance coverage before the premiums are contributed to the pool. Actuarial gains are a distribution to beneficiaries from the pool of premiums that have presumably borne tax in the hands of the taxpayers who paid the premiums. The income tax is said to be a tax on the harvest or earnings of the economy.<sup>18</sup> The transfer of actuarial gain from survivors to the decedent’s beneficiaries is not the creation of new harvest or earnings.

“Winning on your life insurance,” moreover, can only be understood ironically because the death of the insured is ordinarily a tragedy for the dependent beneficiaries. Life insurance is purchased to provide a source of money when it will be most desperately needed. If it were not for the extra value of money at times of economic loss, no policyholder would be willing to bear the extra transaction costs of insurance. Moreover, although policyholders who survive the year can be said to have economically lost their premiums, they get peace of mind during the term of the coverage. Because life insurance proceeds are paid to beneficiaries in especially dire circumstances and because even surviving policyholders derive a benefit from their policies, imposing tax upfront on the income used to pay premiums, rather than on the actuarial “winner,” satisfies the Treasury’s revenue needs and avoids tax at time of critical need.

The system of exempting gains but not allowing a deduction for lost premiums is not a subsidy to life insurance, but rather, an appropriate adjustment of progressive rates to fit the circumstances. Assume first that tax rates are flat. Viewed from the front side, before the insured knows whether the policy will “pay off,” exemption is no advantage: If tax rates are constant, the

*Commissioner*, 113 T.C. 254 (1999), *aff’d per curiam*, 254 F.3d 1313 (11th Cir. 2001), *Doc 2001-18038*, 2001 TNT 127-6, *cert. denied*, 535 U.S. 986 (2002).

<sup>12</sup>Yoram Keinan, “The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine,” *Tax Notes*, Apr. 17, 2006, p. 327, *Doc 2006-6617*, 2006 TNT 74-29.

<sup>13</sup>Section 264(a)(3), (a)(4), (d), and (e). Rank-and-file COLI plans have been broadly criticized and have sometimes been referred to as “janitor’s insurance”; Andrew D. Pike, CRS Report RL3200, “Taxation of Life Insurance Products: Background and Issues,” 18-21 (2003), *Doc 2003-23120*, 2003 TNT 206-20. Section 264(f), enacted in 1997, broadly reduces deductible interest pro rata by the amount by which unborrowed cash reserves in life insurance policies bears to the basis of all assets.

<sup>14</sup>*Brown v. Helvering*, 291 U.S. 193 (1934).

<sup>15</sup>See Kenneth Black and Harold D. Skipper, *Life and Health Insurance* (13th ed. 2000) at 962.

<sup>16</sup>Section 72(e)(3)(A)(ii) (distributions not in the nature of annuity get recovery of “investment in the contract”); section 72(b)(1)(setting up an exclusion ratio for annuities based on unrecovered “investment in the contract”); section 72(c)(1) (defining “investment in the contract” to include all premiums reduced by prior withdrawals of cash).

<sup>17</sup>Section 264(a)(1).

<sup>18</sup>Alvin Warren, “Would a Consumption Tax be Fairer Than an Income Tax,” 89 *Yale L.J.* 1081, 1091 (1980) (income tax is just logical concomitant of the proposition that society in general has a claim on its annual product that is before the claims of individual citizens).

expected value of always taxing the premiums put into the pool will be equal to the expected value of a system that taxes gains and recognizes losses. Treasury would be indifferent to taxing 286 premiums put into an actuarial pool, for example, versus taxing the single \$1 million payout on the pool. And if Treasury was indifferent, insureds would be indifferent on the front side when transactions are entered into because the expected tax would be the same.

In a progressive tax system, large proceeds paid at death could be taxed at higher rates than the rate allowed to compute loss. We believe that result is a misapplication of the underlying rationale for progressive tax. Progressive tax, by looking to the amount of income received in the year, tries to subject sums that will be used for high standards of living to higher rates than sums that will be used for subsistence or modest standards of living. Large life insurance proceeds, however, bunch support amounts to be used for many years into a single year. Consequently, they will falsely appear to be for a high standard of living if the actuarial gain is taxed. Insurance proceeds tend to come in times of dire need. The proceeds are used for many years, and do not ordinarily represent luxury consumption, even when large. A system of always taxing premiums but not payouts is appropriate in this situation.

There are other transactions in which a winner takes a pool, including, for example, office betting pools on football games. We considered, and decided not to propose, exempting gains but not allowing losses in other risk pools. Other pools are unlikely to have the characteristics of life insurance, which is that proceeds are received at times of exceptional need. The ordinary function of a tax system's computation of economic income is to separate winners from losers. Thus, outside life insurance, we think that an income tax should tax gains and losses, even though we recommend exemption of actuarial gains and losses within life insurance.

We considered but decided not to propose taxing corporations or other business entities differently, by taxing actuarial gain and allowing loss when premiums turn out to exceed the insurance proceeds. For a corporation, the insurance policy is a bet, not unlike other forms of covering loss, including credit default swaps, short sales, and put options. For a corporation, the receipt of life insurance proceeds does not compensate for the loss of a spouse or parent. The company does not have high utility for money received in the valleys of earnings because the business entity is just an artificial entity. For those reasons, one might require business entities to capitalize their premiums as the cost of a viable investment but be allowed to deduct the premiums, either against proceeds or as a separate loss, at the end of the term when the premiums expire in value.

We ultimately do not recommend a different treatment of individual and business entity beneficiaries on that issue. A major reason for rejecting that approach is the simplicity of a single regime for all beneficiaries. Because our proposal taxes the policy owner who paid the premiums, rather than the beneficiary, the beneficiary is otherwise irrelevant to the proposed tax regime. Some entities, such as partnerships, straddle the world of business and individuals. An ambiguity about which of

two tax regimes applies would mean that many border transactions would slip through the cracks. Two separate systems would also allow taxpayers to switch regimes by changing beneficiaries. We cannot recommend a system that would allow an election to the detriment of the Treasury revenue by switching the designation of beneficiaries.

**2. Earnings on life insurance products.** By contrast, exemption of earnings from investment in life insurance is not justified. A life insurance contract is an investment vehicle that has only modest differences from other investment vehicles, including bank accounts, financial derivatives, and mutual funds. The forms of investment are converging. Risk coverage can be found in financial instruments not traditionally thought of as insurance products. Variable returns dependent on market results or straight interest returns are found in products marketed by insurance companies.<sup>19</sup> At the level of abstraction at which financial analysis is conducted, a life insurance policy is merely a savings account or a mutual fund that generates an annual rate of return, with the attachment of an annual bet on the insured's death. If the financial institution operates as a mutual fund or a bank, the deposit owner is taxed on the interest earned, even if the interest is not withdrawn from the bank. If the financial institution is called a life insurance company, the true owner of the earnings is not taxed unless (and until) the earnings are withdrawn during life. The label on the building does not justify the radical difference in tax results. Section 7702(g) now taxes the annual interest from a life insurance contract when the investment element or cash surrender value goes beyond traditional forms of insurance and swamps the annual bet. The rationale behind our proposal is that the tax treatment mandated by section 7702(g) is appropriate as a neutral accounting, even when the contract contains important life insurance coverage in addition to the investment returns.

The exemption for earnings on life insurance is also anomalous because the proceeds ordinarily replace taxable salary. Life insurance's primary nontax function is to provide for beneficiaries by replacing the insured's salary in the event of the insured's death. If the insured had not died and had continued to receive a salary, that salary would have been subject to tax.<sup>20</sup> Furthermore, if the insured had saved to provide for her dependent survivors, the interest or dividend earnings would have been subject to income tax.<sup>21</sup>

The tax advantage given to earnings through an insurance contract acts as an unbudgeted subsidy to wealthy insured individuals and to insurance companies. When subsidies are off budget, they never have to pass the strictures that apply to direct government spending. Tax subsidies are always less examined and less justified. The tax subsidy allows insurance companies to credit

<sup>19</sup>See, e.g., David S. Miller, "Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace," *Tax Lawyer* No. 2 Winter (2002).

<sup>20</sup>Section 61(a)(1).

<sup>21</sup>Section 61(a)(4) and (7).

relatively low rates of return to insureds. The Treasury loses tax revenue to subsidize those inefficient arrangements. Competition between financial instruments and financial intermediaries should be played on a level playing field, with no instruments or investment vehicles receiving tax exemption.

The inappropriateness of tax exemption is especially clear when a corporation or other business entity is the beneficiary of the policy. Corporations are not grieving widows or orphans. For the corporation, the insurance policy is just money. Tax accounting needs to be neutral among financial instruments, and for the corporation, the policy is merely a financial instrument.

Exemption of current earnings is also inappropriate for grown and self-sufficient children who are no longer dependent on the insured for support. Although tax exemption of internal buildup is a privilege that all beneficiaries would like to preserve, there is no special merit to life insurance policies over competing investment products. If life insurance does have nontax merits, then it will win the competition for investment funds, even on a level playing field that is neutral among savings and investment vehicles. But the competition should be among nontax advantages — without a thumb on the scale from tax subsidies.

**3. Reduce basis by insurance cost.** The rationale for the exclusion of actuarial gains is that the contribution to the actuarial pool is made with money that has been taxed. That rationale makes it necessary to adjust the holder's "investment in the contract," which may be recovered against distribution during life, to take out the cost of insurance over the prior and current year. Using a cost as an exclusion has the same effect as deducting the cost. Excluding or deducting the contribution to the pool violate the rationale underlying the exclusion of actuarial gain that all contributions to the pool are from post-tax money. Accordingly, the proposal reduces the recoverable "investment in the contract" by the cost of insurance for current and prior periods.

### C. Explanation of the Provision

The proposal would continue the tax exemption for actuarial gain from a life insurance policy, but it would currently tax the policyholder on earnings, even for policies that qualify as life insurance contracts under section 7702. Traditional whole-life insurance gives a return based on a guaranteed rate of return on principal, which is equivalent to bank account or bond interest. The proposal would tax that return as ordinary income. However, for life insurance that specifies an investment return that depends on changes in the value of a separate fund comparable to a mutual fund, the investment returns would be taxed in the same manner as investments in mutual funds. For actuarial gains and losses, contributions to the actuarial pool would be nondeductible, and distribution of the pool to a decedent's beneficiaries would not be taxable.

**1. Earnings from an insurance contract.** Under the proposal, the owner of the insurance policy would have ordinary income in each tax year equal to the "earnings from a life insurance contract." The earnings from the life insurance contract would be equal to the increase in the cash surrender value of the policy, plus the cost of

insurance (that is, the statistically necessary contribution to the actuarial pool) reduced by the premiums paid on the policy. The treatment is the same as taxing the earnings on the life insurance policy because earnings will either cover the cost of insurance or increase the policy's cash surrender value. The treatment is the same as that applied under current law when investment features of the contract are too large to fit within the limitations generally adopted as descriptions of traditional life insurance.<sup>22</sup> Under the proposal the earnings from the contract would be taxed even if the arrangement qualifies as a "life insurance contract." The insurance company would file an information return, advise the policyholder of the "earnings from a life insurance policy," and withhold tax on "earnings from a life insurance contract." The earnings would become taxable ordinary income to the policyholder, but the information return would also state the tax withheld. The tax withheld would constitute a tax payment that could be refunded to the policyholder if the tax finally calculated to be due was less than the tax withheld from insurance and all other sources.

Ordinary income is the appropriate result for most traditional life insurance, in which the insurance company provides a guaranteed rate of return on principal. The earnings that build up the cash surrender value to the insured and the payment for contributions to the actuarial pool to cover pure insurance are in the nature of interest.

The proposal recognizes, however, that an insurance company may market a life insurance policy, such as variable life insurance, in which the investment return credited to the policy reflects the return on a designated pool of investments that is functionally equivalent to a mutual fund. If the insured's return is contingent on the performance of stock and bonds within that fund, then the insured would be taxed under normal mutual fund rules. Consequently, the fund's realized capital gains, interest, and dividends allocable to a particular policy would be taxed currently under the tax rules that would apply to owners of interests in a mutual fund. If the mutual fund has unrealized appreciation on the stock, the insured would not pay tax on the realization until the stock is sold by the fund. If the annual cost of insurance coverage exceeds the annual premium payment, the taxpayer would be deemed to realize an amount of gain equal to the difference.

**2. Actuarial gain.** The proposal would not tax actuarial gain from life insurance. Premium payments would not be deductible, and distributions from the pool to the decedent's beneficiaries would not be included in income. Premiums would never be deductible, whether paid in connection with business income or for personal reasons. The Treasury would achieve its revenue because premiums and contributions to the actuarial pool would not be deductible, and the IRS would collect tax at the policyholder's tax rate on moneys that went into the pool and on earnings. Once premiums and earnings are taxed, there is no need to tax withdrawals as well.

<sup>22</sup>Section 7702(g).

**3. Interest deductions.** Because current law provides an exemption for investment returns from life insurance, it partially prevents the deduction of interest incurred to buy or carry life insurance.<sup>23</sup> Once earnings from life insurance are taxed, however, the special limitations on the interest deduction would not be appropriate. Under the proposal, they would be repealed. Interest to buy or carry life insurance would be investment interest, which under section 163(d) is allowed only to the extent of ordinary income from investments.

**4. Reduction of basis by insurance cost.** The proposal would amend section 72(c)(1) to add a new (C) that would reduce the taxpayer's "investment in the contract" by the cost of insurance coverage in the current and prior periods. Current law anomalously allows all premiums to be excluded as a recovery of capital against distributions from the policy during life. The rationale for exclusion of actuarial gains, however, is that the cost of life insurance protection be made from after-tax income. Using the contributions to the pool as an exclusion against cash surrender value has the same effect as a deduction and violates the premise that all contributions are post tax. The exclusion for contributions under current law against cash distribution breaches the rationale for exclusion of actuarial gains.

#### D. Alternatives Considered but Not Recommended

**1. Tax insurance company alone on earnings?** We considered but do not recommend taxing the insurance company on the investment income credited to policyholders' cash value while exempting the insured from taxation of the earnings in full. Imposing a single 35 percent tax rate on all earnings would be simpler than withholding tax according to the policyholder's tax rate. Revenue is lost because the Treasury will need to reach a large group of policyholders rather than the single insurance company. The general corporate rate, now at 35 percent, is higher than the tax rate for all individual holders except those in the highest tax bracket.

Withholding on the taxable income on behalf of the policyholder would allow an individual subject to a maximum marginal tax rate lower than 35 percent to pay tax on the income from a life insurance contract at rates that reflect the individual's own economic circumstances. Moreover, if the individual tax rate rises above 35 percent in the future, life insurance should not be an investment that allows high-income investors to obtain a relative tax shelter at a lower (35 percent) rate. The proposal accordingly taxes the insurance company only on taxable income allocated to the company, and allocates the rest of the taxable income, via an information return and withholding, to the policyholders to report on their tax returns.

**2. Tax beneficiaries on earnings?** An alternative also considered but not proposed here would be to tax the

beneficiaries of the policy, rather than the holder, on the annual taxable income. The beneficiaries are the ones who will ultimately receive and consume the proceeds of the insurance. However, section 102 creates a general framework under which money used for gifts and support are taxable not to the recipient, but at the source. In general, a household wage earner pays tax on salary as it comes into the household, and the cash may be transferred within the household as a gift or support without further tax. The major social function of life insurance is to provide continued support to dependants of the insured who paid the premiums. Accordingly, the proposal puts the taxation of life insurance products into the framework of support and gifts.

The policyholder who is taxed on annual income from the policy would ordinarily be the individual or business entity that paid the premiums. But if the premiums are reported as gifts, the corpus of the policy would be transferred to the new policyholder and that donee would then be the holder to whom the income is taxed. This also is the general framework for gifts, under which the donee is taxed on subsequent income from a gift of property.<sup>24</sup>

**3. Exemption if dependents are beneficiaries?** Another alternative not proposed here is to continue the tax exemption for earnings dedicated to the primary social function of life insurance, which is to provide continuing support for dependents of the insured. Dependents are defined under current law by section 152 as certain relatives of the taxpayer whose support comes primarily from the taxpayer. Certainly, if the beneficiary is a corporation or business entity, it is especially appropriate to tax earnings because, to the business entity, the transaction is merely a matter of fungible money. Similarly, once children and spouses become financially independent, the insurance proceeds do not fill in with desperately needed support.

We did not, however, recommend a continued exemption for earnings dedicated to beneficiaries who are dependents of the insured, for instance, minor children. Relatively few families with young dependent children can afford to accumulate significant amounts of cash value in life insurance. Most of the benefit under current law accrues to older insured individuals without dependent children. Moreover, the proposal here would already exempt actuarial gain from term and other life insurance, so that the "gains" from early death would already be tax exempt. Finally, earnings that arise during the dependency of a beneficiary are usually paid out long after the child is no longer a minor. If the 45-year-old insured in our earlier example lives his normal life expectancy, the minor children beneficiaries would receive the earnings 33 years later, at which time they can be expected to be financially independent.

<sup>23</sup>Section 164(a)(2), (3), and (4).

<sup>24</sup>Section 102(b).