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WHAT'S ON THE SHELF? A PROPOSAL TO TAX THE INSIDE BUILDUP

By Brian G. King[1]

The current condition of the United States economy can easily be characterized as a period of severe economic downturn. Congress and the American people face numerous financial challenges with the massive bailouts of banks and the auto industry and the potential need for additional bailouts looming ahead as other industries struggle in this economy. Where does the revenue come from to finance these bailouts? Can the deficit continue to grow?

If the repeal of the Alternative Minimum Tax (AMT) becomes a reality, this could result in a significant reduction in federal revenue dollars at a time when the need for these dollars is increasing significantly. This will place even greater pressure on the government to find new ways to generate tax dollars. It's been more than 20 years since the Tax Reform Act of 1986, when Congress last made significant modifications and reforms to the tax base. However, as in the past, the need for revenue can often drive tax reform. Our current economic predicament has created a need for revenue. What will be the nature of the tax reform?

For some, the expectation of this next wave of tax reform has precipitated the development of tax proposals to answer the call of Congress when the need arises. The "Shelf Project"[2] is one such example of this tax reform readiness initiative. One of the proposals currently sitting on the shelf,[3] would have very significant consequences for the United States life insurance industry and its policyholders.

WHAT IS THE "SHELF PROJECT?"

The Shelf Project is a collaborative effort by academics in the tax community with the stated intention of developing "well thought out" tax proposals, which Congress can consider when the need arises to raise revenue. The theory behind developing these proposals in advance of their need is that shelf proposals can sometimes take years to develop. By having them ready to go, Congress has proposals to "take off the shelf" when the need to raise revenue does arise. Under this paradigm, it is believed that such planning can eliminate the potential for the passage of flawed tax policy by Congress in its haste to start generating revenue.

The goals of the shelf proposals are to raise revenue, defend the tax base, reduce tax-caused harm, follow the money and improve the rationality and efficiency of the tax system. Through the collaborative efforts of those working on the Shelf Project and the peer review process that accompanies this process, the thought is, at least theoretically, that the shelf proposals can achieve these goals.

One such proposal that sits on the shelf involves changing the tax treatment of life insurance policies. This proposal would tax the earnings on the insurance contract in all cases as it occurs, even if the contract qualifies as a "life insurance contract" under current law. The actuarial gain (*i.e.,* the net amount at risk) would remain tax exempt under this proposal. The rationale behind this exemption is that the dollars used to pay for the contract are after-tax dollars and thus represent amounts already taxed.

However, the rationale for taxing the earnings is based on the viewpoint that life insurance competes with other investment vehicles and there is no justification for taxing investment returns accomplished through a life insurance company more generously than any other vehicle. As such, this proposal views the cash value as an investment, not as a prepayment of future mortality costs. If passed, this proposal quite obviously would impact United States life insurance products and their policyholders, but more significantly, the impetus for developing this policy marks a fundamental change in the tax treatment of life insurance products. It would likely result in a shift in the marketplace from cash value life insurance to term or other less investment-oriented life insurance products.

WHAT ARE THE CURRENT TAX BENEFITS OF LIFE INSURANCE AND HOW HAS THIS TAX TREATMENT EVOLVED?

Since the 1913 inception of an income tax in the United States, life insurance death benefits paid to the beneficiary have been free of federal income tax. In addition, increases in the cash surrender value of life insurance contracts have not been included in the taxable income of policyholders. This benefit is called the tax-deferred inside buildup, or simply the inside

CONTINUED ON **PAGE 16**

buildup. Thus, under current federal income tax rules, the recognition of income earned inside a life insurance contract is deferred until the contract is surrendered and is limited to the gain in the contract (*i.e.*, the excess, if any, of the cash surrender value over the policyholder's investment in the contract). If the policy is held until the death of the insured, no income tax is payable at all.

This current tax treatment of life insurance contracts recognizes the social good that life insurance death benefits offer beneficiaries in the event of the premature death of the insured. In addition, it implicitly acknowledges that the cash value is an integral component of a life insurance contract, as it serves as a prefunding mechanism to offset the higher mortality cost of providing a death benefit at older ages.

Although this tax treatment of life insurance death proceeds has remained basically unchanged for nearly a century, the tax treatment of the inside buildup periodically has come under scrutiny, largely due to changes in product designs and marketing initiatives that have accompanied new products. Understanding the history of these product changes helps in understanding the corresponding changes that have emerged in product tax treatment.

Initially, traditional whole life insurance arose out of a need to make life insurance affordable for the "whole" life of the insured. Yearly renewable term policies had premiums that increased each year, becoming prohibitive for many individuals at the older ages. With traditional level premium whole life insurance, the basic design allowed a prefunding of mortality charges in the early years (the premium exceeded the cost of insurance charges) which were held to pay mortality charges in the later years (when the level premium was less than the cost of insurance charges). This excess prefunding was increased by interest each year to help fund the policy until maturity. Thus this "income" on the policy is actually an integral component of the financing of the policy. It is not, nor was it ever intended to be, a separate "investment component" in traditional whole life insurance.

The availability of a cash surrender value to the policy owner in the event of early termination was introduced as a consumer protection device. It was intended to refund this prefunding amount to the policyholder in the event of early termination since the death benefit would no longer need to be funded. Access to the cash surrender value through loans and withdrawals emerged out of the recognition that granting access to the cash surrender value buildup through these mechanisms could possibly provide further consumer protections—*i.e.*, loans for premiums, emergency access to cash—while keeping the death protection in force.

Life insurance companies through the years have endeavored to develop and market new and innovative life insurance plans. This was especially true during the product revolution of the late 1970s and early 1980s with the transition from basic traditional whole life products to unbundled product designs that explicitly exposed the development of the cash value, including its growth with interest. These new excess interest and universal life product designs were, at times, more investment-oriented than their traditional counterparts. This created a natural tension between those who believe that the current tax treatment of life insurance is an exception from general income tax principles, and would therefore seek to minimize the revenue loss from the life insurance tax "preference," and those who would seek to expand the sale of life insurance products, taking advantage of the applicable tax rules.

Congress's response to these new products and marketing initiatives has generally followed one of two paths: definitional limitations restricting qualifying product designs or limitations in the tax treatment applied to pre-death distributions. The enactment first of section 101(f) and then section 7702 was a response following the first path, while the enactment and enhancement of the section 264 rules (limiting the deduction of interest on borrowing used to finance the purchase of life insurance) and the introduction of the modified endowment contract (MEC) legislation (section 7702A and section 72(e)(10)) which applied the income-first rules to pre-death distributions of certain investment-oriented life insurance contacts was a response following the second path.

Currently, sections 7702 and 7702A, introduced in 1984 and 1988 respectively, define actuarial requirements that serve as the gateway for a life insurance policy sold today to receive the tax treatment described above. More specifically, these sections have resulted in a full definition of the phrase "life insurance contract" in section 7702, and, further, a division of the class of life insurance contracts into those that are MECs, to which more stringent rules regarding policy loans and pre-death distributions will apply, and those that are not MECs.

DISCUSSION OF THE SHELF PROPOSAL TO TAX THE INSIDE BUILDUP

The taxation of life insurance contracts under federal tax law is best understood in the context of the differing views of the current federal income tax rules that apply to life insurance contracts. While the current income tax treatment of life insurance—allowing deferral of tax on the inside buildup—has consistently been the policy of Congress since the very beginning of the income tax, it also has been criticized by some theorists who believe that all accretions to wealth, including the increase in life insurance cash surrender values, should be a part of a comprehensive tax base. In their view, the inside buildup of a life insurance policy would be properly taxed to the policyholder as it accrues, and the failure of the Code to do so results in a tax advantage, or tax preference, giving rise to a "tax expenditure" equal to the untaxed inside buildup.

This accretion to wealth view is shared by the collaborators of the current shelf proposal. Under this proposal, the earnings on the insurance contract would be taxed in all cases as they arise, even if the transaction qualifies under the limitations of "life insurance contract" under current law. Based on the belief that life insurance competes with other investment vehicles, proponents of the shelf proposal feel that there is not sufficient justification for providing more generous tax treatment for investment returns accomplished through a life insurance company than any other investment vehicle. This proposal views the cash value as a pure investment, not as a prepayment of future mortality costs. As such, this investment vehicle needs to compete with other investments based on its non-tax characteristics rather than its tax advantages. Under this viewpoint the current and historic tax treatment of life insurance products has acted as a subsidy.

This view fails to acknowledge the social utility of level funding inherent in cash value life insurance and also fails to acknowledge the significance of the limitations imposed by section 7702, which are based on the concept of prefunding the future costs of the life insurance contract. As such, these limitations are complex and necessarily depend on actuarial concepts and calculations.

While the proposal arguably contains flawed logic[4] that is used to support why the tax deferral on the inside buildup is unjustified, it is not the intent of this article to challenge the positions taken in the proposal. The larger and more troublesome issue inherent in this shelf proposal lies with the concern that Congress may be seeking to broaden the tax base for all taxpayers, thereby eliminating tax preferences that have long been part of the tax code. States are also facing pressures to increase revenues in these difficult economic times. While the shelf proposal preserves the tax-free status of the pure death benefit element of a life insurance contract (*i.e.*, the net amount at risk) for federal income tax purposes, Oregon House Bill 2854,[5] for example, introduced into the 2009 Oregon Legislative Session proposed to include death benefits in the income base of taxpayers.[6] These proposals show an alarming trend, at both the federal and state level, toward drastic changes in the customary taxation of life insurance products for the purpose of increasing revenues.

In the past, when Congress and the courts have felt the need from time to time to draw lines distinguishing life insurance contracts from other financial instruments it was in response to product design and marketing initiatives taken by the insurance industry. Historically, the intent of these responses has been to continue to permit deferral of tax on the inside buildup but only to the extent that it is needed to fund life insurance benefits, and, in some cases, only to the extent that it remains inside the contract. In the past, rather than subjecting the inside buildup to current taxation, Congress has chosen to limit the amount of inside buildup eligible for life insurance tax treatment.

This proposal views the cash value as a pure investment, not as a prepayment of future mortality costs.

CONTINUED ON PAGE 18

WHAT'S ON THE SHELF? … | FROM PAGE 17

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SUMMARY

It is important to note that the current shelf proposal is not a reaction to the creative minds of talented actuaries who from time to time have come up with new designs for life insurance policies which are tax driven investment vehicles and/or tax shelters. Unlike in the past, this is not Congress drawing the line to lower the temperature of too hot a product. Rather, a major motivation for this proposal is purely revenue generation and an increased tax base and its target is the inside buildup of all policies, whether or not they qualify under the definition of life insurance and whether or not the investment component stays within the contract. If successfully implemented, this new tax policy would mark a significant change in the way the life insurance industry is taxed.

The shelf proposal to tax the investment earnings of all life insurance products as they occur is a significant change from the way such policies have been treated in the past. Thus, if passed, there are numerous issues that companies and policyholders will need to address to transition to this different tax treatment. A fair question will be whether cash value life insurance will continue to exist at all? It is important to understand that the shelf proposal to tax the investment component of life insurance policies is currently still sitting on the shelf. However, elements of this proposal are starting to surface. The "Green Book" includes a proposal that would repeal the section 264(f) exception from the pro-rata interest expense disallowance rule for most corporate owned life insurance (COLI) contracts. This repeal would effectively apply a proxy tax on the earnings credited to COLI contracts by denying an otherwise deductible interest expense. Similarly, the recent life settlement rulings (Revenue Rulings 2009-13 and 14) incorporate certain elements of the shelf proposal in the taxation of a life settlement contract. The life insurance industry needs to be aware that the shelf proposal, and others like the Oregon bill, do exist or have been proposed. To the extent that the current administration is looking for ways to raise revenues, simplify the tax code by reducing the number of "preferences" that currently exist, and as a result, broaden the income tax base, the current tax benefits of life insurance will continue to be a target.

END NOTES

1. The author would like to thank John Adney for his input and comments on this article.
2. C. Johnson, *The Shelf Project: Revenue-Raising Projects That Defend the Tax Base*, Tax Analysts, Dec. 10, 2007.
3. C. Johnson, A. Pike & E. Lustig, *Tax on Insurance Buildup*, Tax Analysts, Feb. 2, 2009.
4. In an attempt to highlight the investment nature of life insurance contracts, the shelf proposal article references both a level premium and single premium ordinary life insurance contract that matures at age 78, assuming earnings at an annual effective rate of 5%. Under the current tax law requirements of section 7702, it is unlikely that either example would qualify as a life insurance contract, and therefore be eligible for the tax deferral on the inside buildup.
5. The Oregon bill was strongly opposed by the life insurance industry and was subsequently withdrawn.
6. California and Massachusetts are also considering proposals targeting tax benefits of life insurance.

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