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PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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Comments to The President's Advisory Panel on Federal Tax Reform

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The President's Advisory Panel on Federal Tax Reform
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Members of the Panel:

The American Council of Life Insurers (ACLI)[1] would like to provide the Panel with the following discussion of the tax treatment of life insurance and annuities It has long been recognized that annual earnings credited to life insurance and annuity contract cash values – commonly referred to as "inside buildup" – should not be taxed unless the payments are received by the owner of the policy during his or her lifetime. This treatment of inside buildup is entirely appropriate and should be included in any reform proposal considered by the Tax Reform Panel.

The treatment of inside buildup under current law recognizes and implements a fundamental tax principle related to the realization of income and achieves important policy objectives. That is why, throughout the history of our income tax system, Congress has always provided that the earnings on a life insurance or annuity contract would only be taxed on distribution of the proceeds.[2] This tax policy principle is equally applicable to <u>any</u> income tax system and it is important that it be understood as consideration of reform proposals move forward.

[1] ACLI represents 354 life insurance companies operating in the United States These 354 member companies account for 74 percent of the industry's total assets, 69 percent of the life insurance premiums, 79 percent of annuity considerations, 51 percent of disability income insurance premiums, and 81 percent of long-term care insurance premiums in the United States

[2] Generally, under current law, inside buildup credited to an annuity contract is not taxed while the account balances under the contract are held by the insurance company, such as while the annuity is in its "accumulation" phase; rather, such earnings are taxed (as ordinary income) only as payments are made from the annuity contract or if the annuity contract is used as collateral for a loan. Inside buildup on a life insurance contract is taxed as ordinary

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This paper will discuss this fundamental principle -- that appreciation in the value of assets generally should not be taxed until the appreciation is realized (the "realization principle") -- and how the current tax treatment of inside buildup implements that principle. The paper then will discuss how the current tax treatment of inside buildup preserves neutrality among different kinds of financial investments where gains are similarly untaxed until the assets are converted to cash or exchanged for another investment. Finally, it will discuss how the current law treatment of inside buildup mitigates against potential under-insuring and potential under-investing in long term savings.

Taxing Inside Buildup is Inconsistent with the Realization Principle

A theoretically "pure" income tax (such as one based on the Haig-Simon definition of income) would treat all increases in economic position as income and all decreases as a loss. The United States has never had such a theoretically pure income tax nor, to our knowledge, has any other country. Moreover, it is unlikely we would want one. Although such a system would work in theory, it would be judged impractical and unfair by the vast majority of people called upon to pay tax under it.

One way in which a real world tax system deviates from a theoretically pure system is that it embraces the "realization principle." Under this principle, increases in the value of assets such as stocks, bonds, and real estate are not taxed (and decreases in the value of such assets do not result in refunds) until the asset is sold.[3] At its core, the realization principle acknowledges that it is unfair to tax individuals on their theoretical increases in wealth so long as that wealth has not

income upon the surrender of the insurance contract, but it is not taxed if paid as proceeds of a life insurance contract by reason of the death of the insured.

[3] Accessing increases in the value of assets through the use of the asset as collateral for a loan also generally does not generate tax liability

been reduced to cash or some other liquid form. Stated another way, it is inherently unfair (with rare exceptions) to tax people on their increases in wealth until they have the means to pay those taxes.

We see the realization principle at work throughout current law. Individuals are not taxed annually on the increase in the fair market values of their homes. Commercial real estate is not taxed until the property is sold by its owners. Increases in the value of stocks and bonds are not taxed to the owner until the stocks and bonds are sold.

It is theoretically possible to design a "mark-to-market" income tax that would ignore the realization principle and instead would be based on the principle that all increases in a person's wealth should be taxed as such wealth accrues. A consequence of mark-to-market taxation would be that the increase in the value of a person's home would be taxed every year, as would appreciation in commercial real estate and increases in the value of stocks and bonds held by the individual.[4]

The converse also would be true. A theoretically pure mark-to-market income tax would treat a decrease in the value of a person's investments, such as occurred with the sharp drop in the stock market in 2000, as a tax loss. During economic downturns, this would require gigantic tax refunds from the government to taxpayers who previously paid taxes on unrealized appreciation in stock and other assets.

Implementing theoretical mark-to-market concepts would prove impractical at best in the real world. Mark-to-market regimes are viewed, quite rationally, as unfair because they force

[4] Presumably, if the Panel chose to recommend such a mark-to-market system it would do so for all financial assets in order to achieve fairness and neutrality rather than picking and choosing among types of assets.

individuals to pay tax on gains without receipt of the corresponding cash from which to make the payment. In theory, tax payments required under a mark-to-market regime could be made from other income sources. In practice, however, only the wealthiest of individuals are likely to have sufficient income from other sources with which to make such tax payments. A mark-to-market regime would therefore impose a tremendous burden on less affluent individuals, who might lack the ability to pay the tax without either having to borrow against or even sell the asset in question.

The lack of ability to pay the tax due coupled with the need for refunds when assets decline in value also present difficulties in administering a mark-to-market system. The larger administrative concern with a mark-to-market regime, however, is valuation. A significant portion of the wealth of this country is represented by assets for which there is no established market. Many of these assets are very difficult to value. In situations where asset valuations are required for tax purposes – charitable contributions, for example – disputes over the value of the asset are a hallmark. We have seen demonstrable evidence of this over the last several years as the IRS, Treasury, and Congress have all struggled with abuses in valuation. As a result of such administrative concerns, the tax laws of the United States and other countries generally do not tax gains or permit deduction of losses on investments until property is sold.

The inside buildup in a life insurance or annuity contract is essentially unrealized appreciation in the value of that contract. This unrealized appreciation is directly analogous to appreciation in the value of stocks, bonds, real estate, and other assets. As long as the taxpayer is not in receipt of the earnings credited to the contract, the tax principles on which our income tax system has

always been based dictate that the insured should not be forced to recognize gain on the appreciation in value of the contract and should not be subject to current tax.[5]

While the increase in the value of financial assets held by individual taxpayers is subject to tax only upon realization, earnings paid on the assets (such as dividends and interest) are subject to current taxation. The same is true of assets held by the taxpayer via a "pass-through" entity, such as a mutual fund (*e.g.*, a regulated investment company or RIC). Unlike a pass-through entity, however, life insurance or annuity contracts are not just "wrappers" around other investments, and the insured does not actually receive the dividends or interest. Current tax rules have very specific definitions of and rules relating to life insurance and annuity contracts to ensure they are not investment products masquerading as life insurance or annuity contracts in order to defer current taxation. Moreover, the elements that comprise an insurance contract cannot be separated. That is, a taxpayer can only fully realize the cash value of the policy by terminating the insurance policy (at which time he is taxed on the inside buildup) and thus forfeiting the risk protection for which the insurance policy was acquired. No tax, economic or public policy goal can be served by forcing the insured individual into the position of having to terminate the insurance contract in order to pay the mark-to-market tax due on that policy.

Neutrality Among Comparable Financial Assets is the Goal

As illustrated above, current law treatment of inside buildup is consistent with the tax treatment of unrealized appreciation in other financial assets. Life insurance and annuity contracts, where the owner does not have immediate and unfettered access to such appreciation, have always been viewed as comparable to other illiquid financial assets. Eliminating the current treatment for

[5] The exemption from taxation of proceeds paid under a life insurance policy upon the death of the insured is similar to the income tax treatment of assets held by a decedent. In general, the value of investments is not taxed to heirs upon the death of the investor; rather, basis in these assets is "stepped" up to fair market value, thus exempting from income tax any appreciation during the lifetime of the investor.

inside buildup would impose a mark-to-market tax regime on insurance products even though such a regime is not standard for most other financial assets.[6] This would create significant new bias in the tax system disfavoring insurance products rather than achieving tax neutrality. Current law treatment of life insurance and annuities also makes the tax treatment among tax preferred savings vehicles, insurance products, and "unrestricted" assets (e.g., directly held stocks, bonds, mutual funds, etc.) more neutral by balancing the restrictions on those assets with the tax preferences they receive.[7]

In addition to the realization principle, our tax law also deviates from a theoretically pure income tax model in order to reduce the bias against savings inherent in any income tax. It does so by creating tax-preferred, restricted savings vehicles that encourage families to save for their long-term financial security. In particular, U.S. tax laws have long exempted from tax the investment earnings on assets placed in restricted, "qualified" savings accounts (*e.g.*, pensions, IRAs, 401(k) and similar plans). The earnings in these accounts are either explicitly exempt from tax, in the case of the Roth IRA, or are effectively exempt from tax, in the case of deductible plans.[8] At the same time, however, the tax treatment of *unrestricted* financial assets generally follows the pure income tax model by subjecting earnings on assets (dividends and interest) to current income taxation, but deviates from the pure income tax model by taxing appreciation in value only upon realization.[9]

[6] Aside from indebtedness issued with original issue discount, which is frequently held by tax indifferent investors, and is oftentimes readily tradable.
[7] It is important to note that under current law the long-standing balance between the different tax treatments of tax qualified accounts, insurance products, and "general" investments has been significantly altered by favored treatment of capital gains and dividends that does not apply to insurance products. See also footnote 7.
[8] In deductible plans such as 401(k) plans, the upfront tax deduction for contributions effectively offsets the tax imposed upon plan withdrawals. For taxpayers with the same pre-tax incomes, deductible plans and Roth IRAs produce the same economic result.
[9] Nothing prevents an investor from arranging his affairs so as to minimize or eliminate current tax on investments. For example, an investor may choose to invest in and hold non-dividend-paying stocks or mutual funds with an investment objective of minimizing taxes.

Between the two extremes of qualified accounts and unrestricted financial assets is a third category: a limited set of life insurance products where the inside buildup is not subject to current taxation. Life insurance and annuity contracts must be funded with after-tax contributions (there is no tax deduction for contributions), and distributions of inside buildup are subject to ordinary taxation (except in the case of life insurance death benefit payments). As a result, the effective tax on the investment component of life insurance (except in the case of death benefit payments) and annuities is somewhere between the effective tax on the other two categories of financial assets. This is appropriate because, while annuities do not have the same contribution and other limits as pensions and qualified plans, they face other, significant, restrictions not faced by unrestricted investments: namely, a 10% penalty tax on distributions made prior to the taxpayer attaining age 59½. It also should be noted that annuities do not benefit from the reduced tax rates on capital gains and dividends, which result in the actual tax on such insurance products generally being much closer to the tax on unrestricted investments than it is to the tax on pensions.[10] Similarly, life insurance policy holders must forfeit their insurance to fully access the cash value of life insurance policies and pay tax on any gain at ordinary income rates.

The existence of at least three categories of taxation of financial assets – for qualified plans, unrestricted assets, and life insurance products – means that changing the treatment of inside buildup does not, itself, achieve neutral taxation of financial assets. Rather, it only reduces three broad categories of taxation to two. Although the distinction between insurance products and unrestricted assets arguably would be removed, the distinction between insurance products and

[10] Indeed, a recent study conducted by ACLI demonstrates that a typical mix of un-restricted investments designed to accumulate retirement savings and then provide retirement income would face an effective tax rate of approximately 29% for a taxpayer in the 25% tax bracket, while the same taxpayer would face a 25% effective tax rate on annuities.

pensions and qualified plans would grow. Moreover, and more importantly, the distinction between insurance and unrestricted investments would not be eliminated. That distinction would only be removed if the capital gains and dividend portions of inside buildup in insurance products were treated as capital gains, which is not now the case. Otherwise, taxing inside buildup would actually subject insurance products to a higher tax burden than the tax burden for unrestricted investments.

Achieving neutral taxation of all financial assets in an income tax would require wholesale changes in the way we tax financial assets. If we chose to tax all unrealized earnings, we would do so not just for life insurance products but also for stocks and bonds, homes, and interests in commercial real estate. We would also eliminate any preferences for pensions and qualified plans – a change few would recommend in a time of declining savings rates, increasing longevity, and the insolvency issues facing Social Security.

Many of these distinctions exist currently in recognition of the essential public policy need to assist families and individuals in saving for retirement. If this tax distinction remains in a reformed income tax, that same public policy argues that the inside buildup of life insurance and annuities should not be taxed currently because these products enable individuals to save and plan for their long-term financial security. While investments in annuities are not as restricted as investments in pensions or qualified plans, annuities, like qualified plans, are dedicated retirement investments that face significant restrictions on withdrawal. Ongoing changes in American society, including the decline of defined benefit pensions and increasing longevity risk, provide added policy reasons for maintaining the tax deferral for inside buildup in annuities.

Current Law Treatment of Inside Buildup Helps Prevent Underinsurance

Life insurance and annuity contracts provide financial security upon death or retirement.[11] Life insurance policies provide financial certainty for family members upon the death of the insured Similarly, annuities are dedicated retirement savings that can be turned into a lifetime payment stream that continues until the death of the insured

Some argue, however, that the current law treatment of inside buildup leads to over-insurance and excess annuity sales. This conclusion is premised on the theory that in an efficient free market, if there were no taxation, consumers would purchase the "correct" (*i.e.*, economically optimal) amount of insurance or annuity coverage.

However, economic literature has focused not on overinvestment in insurance products but on underinvestment in these products.[12] One possible explanation for under-insurance is that consumers do not adequately judge their long-term financial risks, the very risks for which insurance protection exists. This failure to judge risk adequately creates market imperfections. By definition, a person does not know whether he or she will actually suffer a loss until after the loss has occurred, by which time it is too late to do anything about it There are always people who think they can beat the odds and are therefore willing to dramatically under-insure. We see this phenomenon each and every day in the context of car insurance. Left to their own devices, many individuals would either under-insure or go without insurance altogether. This is why state governments mandate that drivers carry auto-insurance.

[11] *See* "Comments to the President's Advisory Panel on Federal Tax Reform filed on behalf of American Council of Life Insurers" dated March 18, 2005 [hereinafter "ACLI March Submission"]

[12] *See* Jeffrey R. Brown, *Life Annuities and Uncertain Lifetimes*, NBER Reporter (Spring 2004) note 9, for a summary of the literature. *See also*, National Academy of Social Insurance, *Uncharted Waters Paying Benefits from Individual Accounts in Federal Retirement Policy*, p. 160 (2005), note 8, at 54-55

We do not mean to suggest that the government should mandate the purchase of life insurance and annuities. But neither should it make the purchase of insurance prohibitively expensive by imposing tax at a time when the insured does not have the cash to pay the tax. Neither should it increase the cost of insurance for older Americans by eliminating the benefit of premium "smoothing" provided by the current law treatment of inside buildup.[13] There is no evidence to suggest that the current law treatment of inside buildup results in excess insurance purchases. Indeed, the current empirical reality of suboptimal purchases of annuities and life insurance suggests the need for *additional* incentives for such products (perhaps on par with pensions and qualified accounts) rather than the removal of such incentives.[14]

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Conclusions

Current law treatment of inside buildup is consistent with the historical and important role played by the realization principle in our tax system. Moreover, it supports the goal of enhancing the country's long-term financial security.

The American Council of Life Insurers urges the panel to strive for neutrality in the taxation of life insurance and annuity products. We stand ready to assist the Advisory Panel as you move forward with your recommendations for reform of the tax system.

[13] The cost of life insurance increases with age because the risk of death increases with age. Permanent insurance ("whole life"), offers level premiums that are more affordable throughout an individual's lifetime. The higher-than-term premiums at younger ages generates growth inside the insurance contract and generates earnings (inside buildup) to cover a significant part of the cost of insurance as the insured ages.

[14] *See* ACLI March Submission; *supra* note 10, for a further discussion.

On behalf of our member companies, ACLI looks forward to working with the Panel regarding the issues raised in this letter. Any questions or comments on these issues are welcome.

Sincerely yours,

Frank Keating