[JOINT COMMITTEE PRINT]

TAX TREATMENT OF SINGLE PREMIUM AND OTHER INVESTMENT-ORIENTED LIFE INSURANCE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON MARCH 25, 1988

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

ıis pamphlet,[1] prepared by the staff of the Joint Committee on ıtion, provides a discussion of present law, current issues, and ible proposals relating to the tax treatment of single premium other investment-oriented life insurance. The Subcommittee on ıtion and Debt Management of the Senate Committee on Fi- :e has scheduled a public hearing on March 25, 1988, to review tax provisions designed to promote life insurance to determine ther such provisions are being used to encourage a particular ı of investment over others. In addition, the hearing will con- r alternatives to the present-law tax treatment to address any ılems that are identified.

ırt I of the pamphlet contains a description of the various types ife insurance products currently being marketed; it also de- ›es the present-law tax treatment of life insurance policies to :yholders and life insurance companies and provides a compari- of the tax treatment of other tax-favored forms of savings and ›stment. Part II of the pamphlet contains an analysis of the tax ›fits available from investment-oriented insurance products, fol- ›d in Part III by a discussion of the issues relating to the ›ent-law tax treatment. In Part IV of the pamphlet, various pro- ıls (including proposals offered by several industry groups) to lify the tax treatment of life insurance are outlined, and Part V :ains a brief analysis of these proposals.

This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of ˈle Premium and Other Investment-Oriented Life Insurance* (JCS-7-88), March 23, 1988.

I. BACKGROUND AND PRESENT LAW

A. Background

In general

The traditional goal of life insurance has been to protect the p icyholder's beneficiaries (usually the policyholder's family) agair a loss of income and costs arising from the death of the pers whose life was insured. This goal is accomplished by pooling t probable cost of the same types of risk of loss over a large numb of policyholders.

In many cases, a life insurance policy will combine two e ments—pure insurance protection and an investment componei The investment component (commonly referred to as cash valı arises if the premiums paid by the policyholder in any year (other policy term), less certain charges and plus credited earnin exceeds the cost of insurance coverage provided to the policyholc for the year (or term). This buildup of cash value allows the pa ment, in later years, of premiums that are less than the curre cost of the insurance protection.

An overview of the principal types of life insurance products cı rently being sold follows.

Term insurance

Term insurance is a contract that furnishes life insurance prot tion for a limited term. The face value of the policy is payable death occurs during the stipulated term of the contract. Nothing paid if the individual on whose life the insurance is provided sı vives to the end of the term. Premium charges only cover the ri of death so little or no cash value builds up over the term of t policy. For any given amount of life insurance, premium charg increase with the policyholder's age because the risk of death (i. the mortality charge) is age-related. As a result, term insurar may be impractical as a policyholder ages because the term cost insurance approaches a significant percentage of the face amou of the policy.

Term insurance policies are most frequently issued for a peri of one year, although a term insurance policy may provide prot tion for a shorter period (such as the duration of a plane flight) a longer period (such as the life expectancy of an individual). ; though term insurance contracts are primarily protection cc tracts, the leveling of a premium over a long period of years p duces a small cash value that increases to a point and then (clines to zero at the termination of the contract.

'hole life insurance

In general

A whole life insurance contract provides for the payment of the ce value of the policy upon the death of the insured; payment is ɔt contingent upon death occurring within a specified period. ıch protection may be purchased under either of two principal 'pes of contract: (1) an ordinary life contract, or (2) a limited payent life contract. The chief difference between the two is the ethod of premium payments.

The ordinary life contract assumes that premiums will be paid ı a level basis throughout the insured's lifetime. In the early ears, the annual level premium is in excess of the amount reuired to pay the current cost of the insurance protection (i.e., the urrent cost of term insurance in an amount equal to the differnce between the face amount of the policy and its cash value). The alance that is retained by the company, at interest, produces a ınd which is called the cash value of the policy. This cash value educes the insurance element in later years when the annual level remium would no longer cover the annual cost of term insurance ı the face amount. The cash value accumulation continues until eaching the face value of the policy at maturity (which occurs 'hen the insured reaches a specified age, typically age 95 or 100).

Under the limited payment life contract, premiums are charged ɔr a limited number of years (such as 10 or 20 years). After the remium payment period, the cash value of the policy, together ith interest credited, is sufficient to pay the cost of term insurnce protection for the remainder of the period that the policy is in ffect. The premium under such a contract will be significantly arger than the aggregate amount of premiums paid during the ame period under an ordinary life contract so that the company an carry the policy to maturity without further charges.

The insurance element in a whole life policy is the difference between the face amount and the cash value. The cash value that acumulates at interest to maturity of the contract is the investment lement in the policy.

Single premium life insurance

The most extreme form of limited payment whole life insurance s single premium life insurance. Under a single premium life insurance contract, a paid-up policy is purchased at policy inception with a single premium payment, or a few initial payments, rather than a longer series of premium payments. Such a policy maximizes the investment element of the policy in the initial years after policy inception. In the case of single premium life insurance, the investment component of the initial premium is so large that no additional premiums need to be paid for insurance coverage.

Universal life

The savings or investment feature of life insurance is also characteristic of other permanent plans of life insurance, such as universal life. Universal life insurance is a whole life insurance contract that retains the investment and insurance features of traditional life insurance products, while disclosing the charges for insurance and the interest rate credited to the policyholder. Univer sal life is distinguished from traditional whole life insurance prod ucts in that the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for in creases) and vary the amount or timing of premium payments. Pre miums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is cred ited at rates that may change from time to time above a minimun rate guaranteed in the contract.

A universal life insurance policy generally offers the policyholde a basic death benefit equal to (1) a fixed face amount, or (2) th sum of a fixed amount plus the cash value of the policy as of th death of the insured.

In a universal life policy, the investment element is the cas value that accumulates at interest, which interest may be adjuste above a minimum guaranteed rate to reflect market interest rate As under a traditional whole life insurance policy, the insuranc element of a universal life policy is the difference between the pre scribed death benefit and the cash value.

Variable life

The distinguishing feature of a variable life insurance policy i that the cash value of the policy effectively is invested in shares c a mutual fund. The cash value reflects the value of assets at th time the cash value is computed. In variable life insurance policie the death benefit typically will vary with the value of the underly ing investment account. A variable life insurance contract can b structured as a single premium contract or any other form c whole life insurance contract.

Premiums under variable life insurance contracts purchase unit in a segregated investment account managed by the insurance con pany and are treated as a security subject to the Securities Act c 1933.

Universal variable life insurance

A universal variable contract is a type of variable life insuranc that features a flexible arrangement for paying premiums. In add tion, the policyholder may change the face amount of the polic and vary the amount and frequency of premium payments. Ofte such a policy provides that a guaranteed death benefit will be pai upon the death of the insured, regardless of investment earning

B. Present Law

general

Jnder a fundamental principle of the Federal income tax, ome is subject to tax when it is actually or constructively reved. Income is constructively received by a taxpayer if the ome is credited to the taxpayer's account, set apart for the tax/er, or otherwise made available so that the taxpayer may draw on it at any time or could draw upon it if notice of intent to :hdraw had been given. Thus, for example, interest income cred-d to a savings account or money market fund is taxable to the ner of the account or fund when credited.

Special rules have been adopted under which certain income is t taxable at the time it normally would be taxed under general :ome tax principles. For example, the investment income on iounts contributed (within limits) to an individual retirement arigement (IRA) generally is not includible in income until withawn even though the taxpayer may draw upon the income at any ne.

In the case of life insurance, a special rule also applies under iich the investment income ("inside buildup") earned on premins credited under a contract that meets a statutory definition of e insurance generally is not subject to current taxation to the mer of the policy. In addition, death benefits under such a life surance contract are excluded from the gross income of the recipnt, so that neither the policyholder nor the policyholder's benefiary is ever taxed on the inside buildup if the proceeds of the licy are paid to the policyholder's beneficiary by reason of the ath of the insured.

Distributions from a life insurance contract that are made prior the death of the insured generally are not includible in income the extent that the amounts distributed are less than the taxiyer's basis in the contract.

Amounts borrowed under a life insurance contract generally are ot treated as distributions from the contract. Consequently, the iside buildup attributable to amounts borrowed under a life insurnce contract is not includible in income even though the policyolder has current use of the inside buildup.

Under present law, a life insurance company generally is not ıbject to tax on the inside buildup on a life insurance or annuity ontract because of the reserve deduction rules applicable to life inırance companies.

efinition of life insurance

In general

Under present law, the favorable tax treatment accorded to life nsurance is only available for contracts that satisfy a definition of life insurance that was enacted as part of the Deficit Reduction Ac of 1984 (DEFRA). This definition was adopted to limit the permissi ble investment orientation of life insurance contracts to level more in line with traditional life insurance products.

A life insurance contract is defined as any contract that is a lif insurance contract under the applicable State or foreign law, bu only if the contract meets either of two alternatives: (1) a cas value accumulation test, or (2) a test consisting of a guideline pre mium requirement and a cash value corridor requirement. Which ever test is chosen, that test must be met for the entire life of th contract in order for the contract to be treated as life insurance fo tax purposes. In general, a contract meets the cash value accumu lation test if the cash surrender value may not exceed the ne single premium that would have to be paid to fund future benefit under the contract. A contract generally meets the guideline pre mium/cash value corridor test if the premiums paid under th policy do not exceed certain guideline levels, and the death benefi under the policy is not less than a varying statutory percentage c the cash surrender value of the policy.

If a contract does not satisfy the statutory definition of life insu ance, the sum of (1) the increase in the cash surrender value an (2) the cost of insurance coverage provided under the contract, ove the premiums paid during the year (less any nontaxable distribu tions) is treated as ordinary income received or accrued by the po icyholder during the year, and only the excess of the death benefi over the net surrender value of the contract is excludable from th income of the recipient of the death benefit.

Cash value accumulation test

The cash value accumulation test is intended to allow traditiona whole life policies, with cash values that accumulate based on rea sonable interest rates, to qualify as life insurance contracts.

Under this test, the cash surrender value of the contract, by th terms of the contract, may not at any time exceed the net singl premium which would have to be paid at such time in order t fund the future benefits under the contract assuming the contrac matures no earlier than age 95 for the insured. Thus, this tes allows a recomputation of the limitation (the net single premium at any point in time during the contract period based on the cu rent and future benefits guaranteed under the contract at tha time. The term future benefits means death benefits and endow ment benefits. The death benefit is the amount that is payable i the event of the death of the insured, without regard to any qual fied additional benefits.

Cash surrender value is defined as the cash value of any contrac (i.e., any amount to which the policyholder is entitled upon surrer der and, generally, against which the policyholder can borrow) de termined without regard to any surrender charge, policy loan, o reasonable termination dividend.

The determination of whether a contract satisfies the cash valu accumulation test is made on the basis of the terms of the contrac In making this determination, the net single premium as of an date is computed using a rate of interest that equals the greater c an annual effective rate of 4 percent or the rate or rates guarar ed on the issuance of the contract. The mortality charges taken o account in computing the net single premium are those speci- d in the contract, or, if none are specified in the contract, the ortality charges used in determining the statutory reserves for e contract.

The amount of any qualified additional benefit is not taken into count in determining the net single premium. However, the arge stated in the contract for the qualified additional benefit is eated as a future benefit, thereby increasing the cash value limi- tion by the discounted value of that charge. Qualified additional nefits include guaranteed insurability, accidental death or dis- ility, family term coverage, disability waiver, and any other ben- its prescribed under regulations. In the case of any other addi- onal benefit which is not a qualified additional benefit and which not prefunded, neither the benefit nor the charge for such bene- is taken into account. For example, if a contract provides for isiness term insurance as an additional benefit, neither the term surance coverage nor the charge for the insurance is considered a ture benefit.

Guideline premium and cash value corridor test requirements

In general.—The second alternative test under which a contract ay qualify as a life insurance contract has two requirements: the iideline premium limitation and the cash value corridor. The iideline premium portion of the test distinguishes between con- acts under which the policyholder makes traditional levels of in- estment through premiums and those which involve greater in- estments by the policyholder. The cash value corridor disqualifies ontracts which allow excessive amounts of cash value to build up .e., premiums, plus income on which tax has been deferred) rela- ve to the life insurance risk. In combination, these requirements re intended to limit the definition of life insurance to contracts hat permit relatively modest investment and relatively modest in- estment returns.

Guideline premium limitation.—A life insurance contract meets he guideline premium limitation if the sum of the premiums paid inder the contract does not at any time exceed the greater of the uideline single premium or the sum of the guideline level premi- ims to such date. The guideline single premium for any contract is he premium at issue required to fund future benefits under the ontract. The computation of the guideline single premium must ake into account (1) the mortality charges specified in the con- ract, or, if none are specified, the mortality charges used in deter- nining the statutory reserves for the contract, (2) any other harges specified in the contract (either for expenses or for quali- ied additional benefits), and (3) interest at the greater of a 6-per- ent annual effective rate or the rate or rates guaranteed on the issuance of the contract.

The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract. The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, premiums returned to a policyholder with interest within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income.

Cash value corridor.—A life insurance contract falls within the cash value corridor if the death benefit under the contract at any time is equal to or greater than the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, a life insurance contract that covers an insured person who is 55 years of age at the beginning of a contract year and that has a cash surrender value of $10,000 must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As illustrated by Table 1, the applicable percentage starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5 year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage decreases by the same amount for each year in the age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage is 142.

The statutory table of applicable percentages follows:

Table 1.—Cash Value Corridor

In the case of an insured with an attained age as of the beginning of the contract year of—		The applicable percentages shall decrease by a ratable portion for each full year—	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Computational rules

?resent law provides 4 general rules or assumptions to be ap-ed in computing the limitations set forth in the definitional ;ts. These rules restrict the actual provisions and benefits that ı be offered in a life insurance contract only to the extent that ɜy restrict the allowable cash surrender value (under the cash lue accumulation test) or the allowable funding pattern (under ɘ guideline premium limitation).

First, in computing the net single premium under the cash value cumulation test or the guideline premium limitation under any ntract, the death benefit generally is deemed not to increase at y time during the life of the contract (qualified additional bene-s are treated in the same way).

Second, irrespective of the maturity date actually set forth in the ntract, the maturity date (including the date on which any en-ıwment benefit is payable) is deemed to be no earlier than the ıy on which the insured attains age 95 and no later than the day ı which the insured attains age 100.

Third, for purposes of applying the second computational rule ıd for purposes of determining the cash surrender value on the aturity date under the fourth computational rule, the death bene-ts are deemed to be provided until the maturity date described in ıe second computational rule. This rule, combined with the second ımputational rule, will generally prevent contracts endowing at ıce value before age 95 from qualifying as life insurance. Howev-:, it will allow an endowment benefit at ages before 95 for mounts less than face value.

Fourth, the amount of any endowment benefit, or the sum of any ndowment benefits, is deemed not to exceed the least amount pay-ble as a death benefit at any time under the contract. For these urposes, the term endowment benefit includes the cash surrender alue at the maturity date.

Adjustments

Under present law, proper adjustments must be made for any hange in the future benefits or any qualified additional benefit (or ıny other terms) under a life insurance contract, which was not re-lected in any previous determination made under the definitional ıection. Changes in the future benefits or terms of the contract can ıccur by an action of the company or the policyholder or by the ɔassage of time.

If there is a change in the benefits under (or in other terms of) :he contract that was not reflected in any previous determination ɔr adjustment made under the definitional section, proper adjust-ments must be made in future determinations under the definition. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount that is necessary to enable the contract to meet the applicable definitional test. A portion of the cash distributed to a policyholder as a result of a change in future benefits is treated as being paid first out of income in the contract, rather than as a return of the policyhold-er's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date the contract.

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the altern tive tests under the definition of a life insurance contract, th income on the contract for any taxable year of the policyholder treated as ordinary income received or accrued by the policyhold during that year. In addition, the income on the contract for a prior taxable years is treated as received or accrued during the ta able year in which the contract ceases to meet the definition.

For this purpose, the income on a contract is the amount b which the sum of the increase in the net surrender value of th contract during the taxable year and the cost of life insurance pr tection provided during the year under the contract exceed th amount of premiums paid during the taxable year less an amounts distributed under the contract during the taxable yea that are not includible in income. The cost of life insurance prote tion provided under any contract is the lesser of the cost of indivi ual insurance on the life of the insured as determined on the bas of uniform premiums, computed using 5-year age brackets, or th mortality charge stated in the contract.

Only the excess of the amount of death benefit paid over the n surrender value of the contract is treated as paid under a life i surance contract for purposes of the exclusion from income of th beneficiary.

If a life insurance contract fails to meet the tests in the defin tion, it nonetheless is treated as an insurance contract for othe tax purposes. This insures that the premiums and income credite to failing policies is taken into account by the insurance compan in computing its taxable income. In addition, it insures that a com pany that issues failing policies continues to qualify as an insu ance company.

Treatment of inside buildup

The investment component of a life insurance premium is th portion of the premium not used to pay the pure insurance cost (including the operating, administrative, overhead charges, an profit of the company). This amount, which is added to the cas value of the policy, may be considered comparable to an interes bearing savings deposit. The cash value portion of the life insu ance policy is credited with interest annually for the life of the con tract. This amount of interest is called the inside buildup, an under present law it is not taxed as current income of the policy holder.

In many circumstances, the investment income credited to th account of the policyholder is never taxed. For example, the pro ceeds of the policy paid upon the death of the insured (includin investment income credited to the policy) are excluded from th beneficiary's income (sec. 101). Further, the proceeds of life insu ance may be excluded from the gross estate of the insured (se 2042).

Under other circumstances, a portion of the investment incom earned may be subject to tax. For example, if a policy is cashed i r surrendered) in exchange for its cash surrender value, or if distributions are made in some other fashion, these amounts are xed as ordinary income to the extent that the cumulative amount aid exceeds the policyholder's basis (i.e., the investment in the ontract (secs. 72(e)(5)(A) and 72(e)(6)). The investment in the contract is the difference between the total amount of premiums paid nder the contract and the amount previously received under the ontract that was excludable from gross income. Under these rules, e portion of investment income that was used to pay for term insurance protection is not subject to tax.

Partial surrenders of a life insurance contract that are made rior to the death of the insured generally are not includible in ncome to the extent that the amounts distributed are less than the axpayer's basis in the contract.

The investment income under a life insurance contract may be ubject to tax in certain other instances. Under present law, no ain or loss generally is recognized on the exchange of a contract of ife insurance for another contract of life insurance (sec. 1035). However, any cash that a policyholder receives as a result of an xchange of policies is subject to tax to the extent that there is ncome in the contract.

Borrowing under life insurance contracts

The inside buildup on a life insurance contract generally is not treated as distributed to the policyholder if the policyholder borrows under the policy even though the policyholder has current use of the money. Consequently, the inside buildup under a life insurance contract generally is not taxed at the time of a bona fide policyholder loan.

Under present law, interest on amounts borrowed under a life insurance policy for personal expenditures is treated as nondeductible personal interest (subject to a phase-in rule for taxable years beginning in 1987 through 1990) (sec. 163(h)). Present law also treats as nondeductible the interest on debt with respect to policies covering the life of an officer or employee of, or individual financially interested in, a trade or business carried on by a taxpayer to the extent the debt exceeds $50,000 per officer, employee, or individual (sec. 264(a)(4)).

Policyholder loans at low or no net interest rates are not specifically subject to the below-market loan rules under present law.

Comparison of tax-favored forms of investment

In general.—The tax treatment of cash value (whole) life insurance contracts compares favorably with the tax treatment of other tax-favored forms of investment under present law. Tax incentives are used to encourage retirement savings through deferred annuity contracts, individual retirement arrangements (IRAs), and qualified pension plans (including qualified cash or deferred arrangements (401(k) plans) and Keogh plans (for self-employed individuals)).

Contribution limits.—Under present law, limits are imposed on contributions to qualified pension plans and IRAs, without regard to whether the contributions to such plans are deductible or nondeductible. On the other hand, limitations are not imposed on the amount of premiums paid for life insurance or the amount that i credited to the cash surrender value of a life insurance contract

Distribution rules.—Special rules apply under present law to pre vent the use of qualified pension plans, IRAs, and deferred annu ities for nonretirement purposes. Under these rules, any distribu tion from a qualified plan or IRA is treated as a pro rata recover of income and basis. Under a deferred annuity, distributions prio to the annuity starting date are treated as income first and then a a nontaxable recovery of basis. Partial surrenders and other with drawals under a life insurance contract are treated as basis firs and then income under present law.

In addition, under qualified plans, IRAs, and deferred annuities an additional 10-percent income tax is imposed on income attribut able to distributions that occur prior to the attainment of age 59½ death, disability, annuitization, and certain other events. This addi tional tax is intended to recapture partially the tax benefits of de ferral when tax-favored savings are not used for their intende purposes. The 10-percent early withdrawal tax does not apply t life insurance contracts under present law.

Finally, under present law, an overall limit is imposed on th amounts that can be distributed to a taxpayer during any taxabl year from all qualified pension plans and IRAs. This overall limi is enforced by an excise tax on any excess distributions. There is n limitation on the annual amount that may be withdrawn from a life insurance contract.

Nondiscrimination rules.—The present-law rules for qualified pension plans allow the favorable tax treatment only if the plan complies with nondiscrimination rules that are intended to ensure that the plan does not disproportionately favor highly compensated individuals. Similarly, the most favorable tax treatment of IRAs (deductibility of contributions) is disallowed for married taxpayers with adjusted gross income above $50,000 (if either spouse is an active participant in a qualified pension plan). On the other hand the favorable tax treatment of deferred annuities and whole life in surance is not conditioned on the income level of the taxpayer.

Loan restrictions.—In the case of most tax-favored forms of in vestment, present law provides restrictions on borrowing to pre vent current use of tax-deferred income. Thus, in the case of de ferred annuities, loans generally are treated as taxable distribu tions. In the case of qualified pension plans, loans in excess of the lesser of $50,000 or 50 percent of the individual's accrued benefit generally are treated as taxable distributions. No borrowing is per mitted from an IRA.

In the case of deferred annuities, loans generally are treated as taxable distributions of income first and then basis. By contrast, no limitations currently apply to borrowing from a whole life insur ance contract, other than restrictions on deductions for personal in terest and for interest on loans by nonindividual holders of such contracts.

Limitations on tax benefits for corporate owners or beneficiaries.—Finally, the favorable tax treatment for IRAs, qualified ans, and deferred annuities is restricted to the situation in which individual is the owner or ultimate beneficiary of the investent. In the case of whole life insurance, however, the favorable x treatment is also allowed for corporate owners or beneficiaries.

Table 2 shows the comparative treatment of these various forms investment under present law.

Table 2.—Comparison of Present Law for Various Tax-Favored Savings Arrangements

Item	Life insurance	IRAs	401(k) Plans	Qualified Pension Plans (Including Keogh Plans)	Deferred Annuities
Limits on contributions	None	The maximum contribution for a year is $2,000 (including both deductible and nondeductible amounts).	The maximum elective contribution for a year is $7,000.	The maximum annual contribution on behalf of an individual to a defined contribution plan cannot exceed the lesser of (1) $30,000 or (2) 25 percent of the individual's compensation.	None, but corporate holders of deferred annuities are taxed currently on the inside buildup on the contract.
Early withdrawal tax	None	A 10-percent additional income tax applies to distributions from an IRA other than distributions— (1) after the IRA owner attains 59½, (2) after the death of the IRA owner, (3) due to the disability of the IRA owner, or (4) which are part of a series of substantially equal payments for the life (or life expectancy) of the IRA owner or joint lives (or joint life expectancies) of the IRA owner and his beneficiary.	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) made after separation from service after age 55, (2) made from an ESOP, (3) to the extent the distribution does not exceed the amount allowable as a deduction for medical expenses, or (4) made to an alternate payee pursuant to a qualified domestic relations order.	Same as 401(k) plans	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) from qualified plans, IRAs, and certain contracts purchased by qualified plans or certain other types of plans, (2) allocable to investment in the contract before August 14, 1982, (3) under a qualified funding asset that is part of a structured settlement agreement, (4) under an immediate annuity contract, or (5) which is purchased by an employer upon termination of a qualified pension plan.

	treated as distributions.		distributions to the extent they exceed the lesser of— (1) $50,000 or (2) ½ of the participant's account balance.		distributions.
Basis recovery	Distributions prior to the death of the insured are treated as a return of the investment in the contract (i.e., basis first).	With respect to amounts received prior to the annuity starting date and annuity distributions, a portion of each distribution is nontaxable in the same proportion as the taxpayer's basis is to the total account balance.	Same as the IRA rules	Same as the IRA rules	Distributions prior to the annuity starting date are treated as income first.
Benefits restricted to individual (e.g., noncorporate) owners	No	Yes	Yes	Yes	Yes.

Tax treatment of insurance companies

Under present law, a life insurance company generally is no subject to tax on the inside buildup on a life insurance or annuit contract because of the life insurance company reserve rules Under these rules, a life insurance company is allowed a deductio for a net increase in life insurance reserves (taking into accoun both premiums and assumed interest credited to the reserves) an must take into income any net decrease in reserves. The net in crease (or net decrease) in reserves is computed by comparing th closing balance to the opening balance for reserves in the sam year. Life insurance reserves are defined to include amounts se aside to mature or liquidate future unaccrued claims arising fro life insurance, annuity, and noncancellable accident and health in surance contracts that involve life, accident, or health continger cies at the time with respect to which the reserve is computed.

The maximum reserve permitted under present law with respec to a contract equals the greater of (1) the net surrender value c the contract or (2) the Federally prescribed tax reserve. In comput ing the Federally prescribed reserve for any type of contract, th tax reserve method applicable to that contract must be used alon with the prevailing National Association of Insurance Commissior ers ("NAIC") standard tables for mortality or morbidity. The as sumed interest rate to be used to discount future obligations i computing the Federally prescribed reserve generally equals th greater of (1) the prevailing State assumed interest rate (generall the highest assumed interest rate permitted to be used in at leas 26 States in computing life insurance reserves for insurance or ar nuity contracts of that type) or (2) the average applicable Federa rate (AFR) of interest (specifically, the average of the applicabl Federal mid-term rates for the most recent 60-month period begir ning after July 1986).

Present law does not treat reserve deductions of insurance com panies as a specific item of tax preference under the corporate a ternative minimum tax.

II. ANALYSIS OF TAX BENEFITS FROM INVESTMENT-ORIENTED LIFE INSURANCE PRODUCTS

ısh value insurance

Under cash value (whole life) insurance, premiums in the initial ›ars after policy issuance exceed premiums for term insurance ·oviding an equivalent death benefit. The excess premium is in›sted and is credited, along with earnings, to the policyholder's ısh surrender value. In the event of the policyholder's death, the ısh surrender value is used to pay a portion of the death benefit. ›nsequently, as the cash value grows over time, it pays an in·easing portion of the death benefit and reduces the mortality ıarge on the contract. Thus, unlike term insurance, which has no ıvestment component, the premiums on a cash value contract do ›t rise with the policyholder's age. In single premium life, the in›stment component of the initial premium is so large that no ad.tional premiums need to be paid for insurance coverage.

Table 3 compares term, ordinary (level premium), and single preıium life insurance for a $100,000 policy acquired by a 55 year old ıale. Premiums and cash value are computed before loading ıarges using the 1980 Commissioner's Standard Ordinary ("CSO") ıortality table and a 6-percent interest rate. At age 55, the premim for term insurance is $988. By comparison, the premium for orinary life insurance is $2,792, and for single premium life insurnce is $33,034. The excess of these premiums over the cost of term ısurance is invested and is credited, along with earnings, to the olicy's cash value.

Table 3.—Term, Ordinary, and Single Premium Insurance [1]

$100,000 death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age of policyholder	Term insurance: Cumulative premium	Term insurance: Cash value	Ordinary life: Cumulative premium	Ordinary life: Cash value	Single premium: Cumulative premium	Single premium: Cash value
5	$988	0	$2,792	$1,933	$33,034	$34,328
0	7,440	0	16,753	12,258	33,034	41,243
5	17,473	0	30,715	23,494	33,034	48,767
0	33,242	0	44,676	35,180	33,034	56,592
5	58,334	0	58,637	46,671	33,034	64,288

[1] Assumes 100 percent of 1980 CSO mortality, 6-percent interest rate, ordinary ife paid up at age 100, premiums paid at beginning of year, and death benefits ›aid at end of year.

Preferential tax treatment of cash value life insurance

The investment component of cash value life insurance receive preferential tax treatment compared to other similar investment such as mutual funds, certificates of deposit, and savings accounts Income credited on such investments is included currently in th investor's taxable income. By contrast, the investment income cred ited to a policyholder under a life insurance contract (referred to a "inside buildup") is not included currently in the policyholder' taxable income. Moreover, the inside buildup on the contract ma be withdrawn tax-free as a loan or partial surrender up to th amount of premiums paid. Finally, benefits paid at death generall are excluded from income. Thus, unlike other investments, life in surance policies allow deferral of tax on investment income, and i the policy is held to death, income tax may be avoided completely

The preferential tax treatment of life insurance can be measure by comparing the policyholder's after-tax investment earning under a contract to that of an individual who invests the cash value in a mutual fund with the same earnings rate. Table 4 com pares, for a 55 year old male in the 28-percent tax bracket, the cash value that would accumulate by age 75 in a life insuranc policy as compared to a mutual fund, both yielding 6 percent pe annum before tax.

For purposes of comparison, it is assumed that the amount in vested in the mutual fund is equal to the premiums paid on each o 4 different insurance policies: an ordinary life policy and thre types of single premium policies. The first single premium policy the "standard" contract, is designed to have the lowest possibl premium and thus the least inside buildup. The other two single premium policies shown in Table 4 are more investment oriented— they are designed to approximate the largest amount of inside buildup allowable under either the cash value accumulation test o the guideline premium/cash value corridor test specified in Code section 7702.[2] In the most investment-oriented single premium poli cies currently being sold, stated charges for mortality and expenses are larger than the insurance company anticipates based on experi ence: this inflation of mortality and expense charges allows the in surance company to offer more inside buildup than otherwise would be the case under the cash value accumulation and guideline premium tests.[3] To reflect the practices of some insurance compa nies, the investment-oriented single premium contracts shown in Table 4 are assumed to state mortality charges of 600 percent of 1980 CSO. (For computing cash value, 100 percent of 1980 CSO is assumed.)

[2] Both policies have an initial death benefit of $100,000. To meet the cash value accumulation and guideline premium tests, the death benefit is increased as necessary.

[3] It is questionable whether such a policy would qualify as life insurance under present law if mortality charges are not reasonably related to the risk being insured.

Table 4.—Comparison of Life Insurance and Mutual Fund Investments [1]

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Item	Ordinary life policy	Single premium policy: Standard policy	Single premium policy: Cash value accum. policy [2]	Single premium policy: Guideline premium policy [2]
Premium or investment	[3] $2,792	$33,034	$68,401	$62,570
Insurance policy alternative:				
Cash value age 75	$46,671	$64,288	$209,301	$191,165
Tax on surrender	$0	$8,751	$39,452	$36,007
After-tax value	$46,671	$55,537	$169,849	$155,159
Mutual fund alternative: [4] Cash value age 75	$96,463	$80,293	$166,258	$152,085
After-tax value of insurance as a percent of mutual fund investment	48.4	69.2	102.2	102.0

[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] Contract states mortality charge of 600 percent of 1980 CSO.

[3] Annual premium; cumulative premiums to age 75 are $58,637.

[4] Insurance premiums invested in mutual fund earning 6 percent before tax (4.32 percent after tax).

Table 4 shows that the cash value in an ordinary life policy grows to $46,671 at age 75 as compared to $96,463 if the premiums were invested in a mutual fund. The cash value in a standard single premium policy grows by age 75 to $64,288 before tax and $55,537 after tax, as compared to $80,293 if the premiums were invested in a mutual fund. Thus, an investor would not purchase either of these insurance policies unless the investor wanted life insurance protection. By comparison, Table 4 shows that for the more investment-oriented single premium products, the after-tax cash value at age 75 exceeds the value of investing the premiums in a mutual fund by approximately 2 percent. Thus, an individual would purchase an investment-oriented single premium life insurance contract even if the individual was indifferent about purchasing life insurance protection because the value of investing in the single premium policy exceeds the value of investing in a mutual fund even after mortality charges for insurance protection.

Another way to analyze the preferential tax treatment of life insurance is to compare a policyholder's tax liability under present law with what the tax liability would have been if inside buildup were subject to tax in the year earned. The difference in tax liability is the benefit the policyholder obtains from the preferential tax treatment of life insurance. The tax benefit may be compared with the value of life insurance coverage purchased. The value of life in surance coverage is the cost of term insurance for the amount o the death benefit not paid for out of the policyholder's cash surren der value. The value of tax benefits relative to the value of life in surance coverage in a policy is a measure of the extent to whic the tax system subsidizes the purchase of life insurance protection

Table 5 illustrates that the present value of tax benefits on a lif insurance policy increases the longer the contract is held becaus the tax on inside buildup is deferred for a longer period of time For example, for a $100,000 ordinary life insurance policy acquire by a 55-year old male, the present value of tax benefits increase from $556 if the policy is surrendered at age 60 to $4,395 if th policy is surrendered at age 75. If the policy is held until death which is presumed to occur at age 76 (the life expectancy of a 5 year-old male), the value of tax benefits is $4,700.

As a percent of the value of insurance coverage purchased, th value of tax benefits on the ordinary life insurance contract in creases from 9.0 percent at age 60 to 17.7 percent at age 75, and i 17.9 percent at death. Thus, in the typical ordinary life insuranc policy purchased at age 55, the tax subsidy is a relatively smal portion (less than 20 percent) of the cost of the insurance coverag purchased.

For the standard single premium policy, the value of tax benefits relative to the value of insurance coverage rises from 31.7 percent after 5 years to 38.9 percent after 20 years, and is 59.6 percent at death. For more investment-oriented single premium products, the value of tax benefits is a much higher percentage of the insurance coverage purchased. For the investment-oriented single premium policies shown in Table 5, the value of tax benefits is about 100 percent of the value of insurance coverage purchased after 15 years, and is over 300 percent of the value of insurance coverage at death.

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age	Present value of tax benefit: policy held to indicated age				Value of tax benefit as a percent of value of insurance coverage			
	Ordinary life policy	Single premium policy			Ordinary life policy	Single premium policy		
		Standard policy	Cash value accum. policy [2]	Guideline premium policy [2]		Standard policy	Cash value accum. policy [2]	Guideline premium policy [2]
60.........	$556	$1,306	$1,094	$1,076	9.0	31.7	60.6	54.4
65.........	1,574	2,796	3,098	2,901	13.2	35.1	85.8	78.8
70.........	2,904	4,551	5,968	5,522	16.0	37.4	104.4	96.9
75.........	4,395	6,477	9,601	8,689	17.7	38.9	118.2	117.0
death [3]..	4,700	10,487	27,210	24,765	17.9	59.6	314.7	321.6

[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Assumes policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] In both the cash value accumulation and the guideline premium policies, the mortality stated in contract is 600 percent of 1980 CSO.

[3] Death assumed to occur at age 76, which is the life expectancy of a male age 55 under the 1980 CSO table.

This analysis illustrates that under present law it is possible t design single premium policies that provide tax benefits to the pol icyholder that are larger than the value of the insurance coverag purchased. In these situations, single premium life insurance ma be purchased exclusively as a tax-advantaged investment even i the policyholder does not need or want life insurance coverage Such a result is likely to occur if the insurance company takes a aggressive position under which stated mortality and expens charges are higher than the life insurance company actuall charges.

III. TAX POLICY ISSUES

A. Overview

n recent years, single premium life insurance and other forms of ; insurance, such as universal life, variable life, and variable uni-sal life, have been marketed as a tax-sheltered investment vehi-. For example, universal life insurance has been described as ving "earned its place in the list of portfolio alternatives. . . [as] permanently tax-sheltered vehicle, offering attractive leverage at ath with the essential risk element centered on fluctuating inter- rates."[4]

Another article suggests that tax-shelter advisors:

> should sell single-premium policies by emphasizing the investment side. The avoidance of current taxation makes SPLs [single premium life] more attractive than CDs or Treasuries. . .Today's SPL policies can provide minimum guaranteed returns roughly comparable to long-term municipal bonds or, for more aggressive clients, returns comparable to mutual funds. . .Single premium variable life offers the growth potential of mutual funds, without current taxation. The best prospects for SPL products are high-bracket investors who want tax-advantaged, long-term savings with an insurance kicker.[5]

A third article indicates that investors and their advisors should k]eep in mind that this [single premium life insurance] is basical- an investment and secondarily a life insurance policy. If your ain concern is insurance coverage, then look to straight insur-ce."[6]

Life insurance companies frequently market single premium life surance policies on the basis of favorable tax rules for loans. One mpany states in its materials:

> THE STORY OF SPL: TAX-DEFERRED INTEREST THAT GIVES YOU TAX-FREE PAYMENTS FOR LIFE
>
> Your first SPL premium will be your last. Immediately, it buys a lifetime of insurance with an initial face amount many times larger than your one and only premium. And immediately you'll start to get some tax benefits you may not even know existed.

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[4] Howard I. Saks, "Single Premium Universal Life Draws Attention as Interest Rates Plum-t," 12 *Estate Planning* 308, 310 (September 1985). See, also, "Firms Offering 'Universal Life' Benefit Plans," *The Wall Street Journal*, 31 (May 9, 1985).

[5] Michael L. Markey, "Single-Premium Life is the Ideal Product for Clients Seeking. . .Invest-nt — With a Life Insurance Kicker," *The Stanger Register*, July 1987.

[6] Nancy Dunnan, "Insure a Tax Break in 1987," *American Bar Association Journal*, May 37.

You see, life insurance is a uniquely tax-advantaged financial product.

Your SPL begins immediately to earn tax-deferred interest at current, competitive rates. . .

And, on the first anniversary of your owning an SPL, you may borrow your accumulated interest tax-free to use any way you choose. . . because the proceeds of life insurance policy loans are **not** subject to federal income tax.

A ZERO INTEREST LOAN

What's more, since . . . keeps paying you high, tax-deferred interest credits **on the total amount of your borrowed values**, your loan costs you nothing . . .

There you have it: policy loans that put income tax-free money into your pocket and reduce the estate value of your life insurance only by the amount of the loans themselves plus interest.

The success of increased marketing of single premium life insu ance is reflected by the sales growth of such policies. Table 6 com pares the growth in single premium life insurance sales with th growth of other whole life insurance sales. The volume of singl premium life insurance sold has increased more than 800 percen since 1984, while the volume of all other whole life insurance sol has increased only 22 percent.

Table 6.—Annual Growth In Single Premium Life Insurance v First Year Premiums For Whole Life Insurance (Excludin Single Premium Life Insurance) [1]

[Dollar amounts in billions]

Year	Single premium		Other whole life	
	Amount	Percent growth	Amount	Percent growth
1984	$1.0		$8.3	
1985	2.5	150	9.5	14
1986	4.9	96	9.3	−2
1987 [2]	9.5	94	10.1	9

[1] This table does not include the amount of policyholder dividends used durin the year to purchase paid-up additions of life insurance coverage.

[2] Preliminary.

Source: Life Insurance Marketing and Research Association, Inc.

The growth in the volume of single premium life insurance sol presents issues relating to the purpose for, and the effectiveness o the favorable tax treatment provided life insurance products. A analysis of the principal tax policy issues follows.

B. Analysis of Specific Tax Policy Issues

[s the favorable tax treatment of life insurance justified?

\ central issue in assessing the present-law tax treatment of life urance products is the appropriateness of excluding from income ; inside buildup on life insurance policies. Even though a policy-lder may have use of amounts earned inside a life insurance icy through loans or partial surrenders, the inside buildup gen-illy is not subject to tax. Further, the tax treatment of life insur-ce is inconsistent with the tax treatment of other investments, ;h as bank certificates of deposit or mutual funds. The tax treat-nt of life insurance is also inconsistent (i.e., significantly more orable with respect to contribution limits, loans, and distribu-ns) with the treatment of tax-favored retirement investment angements, such as IRAs, qualified pension plans (including ogh plans, qualified cash or deferred arrangements (401(k) ins)), and deferred annuities.

The present-law tax treatment permitting deferral of tax (and, netimes, exemption from tax) of the inside buildup on life insur-ce contracts in effect allows taxpayers to purchase life insurance otection with the investment income on the contract that is not rrently subject to tax. This tax treatment operates as an incen-e for taxpayers to provide adequate economic protection against timely death. It may also operate as an incentive for saving.

The incentive to protect against untimely death reflects a social licy goal, implemented indirectly through the tax law, to encour-e individuals to provide for their families' financial security out-le of formal Government programs such as social security and in dition to the private pension system (for which tax incentives are so provided). For example, a situation in which private pension or tirement-related benefits would not provide financial security uld occur when a wage-earner dies suddenly before retirement e and the principal short-term source of funds for the dependents the wage-earner is the proceeds of a life insurance policy.

Various types of life insurance policies can provide the same ath benefit and, thus, the same protection for dependents, with ffering levels of tax benefits due to the different rates at which x-free inside buildup accumulates under each type of policy (see ible 5 above). Present law provides a larger tax incentive with re-ect to single premium life insurance as compared to ordinary life surance, and no incentive with respect to term insurance.

If, as a social policy goal, it is determined that investment come should not be taxed to the extent used to purchase insur-ice protection, then it may be argued that other forms of invest-ent income should not be taxed to the extent used to purchase surance protection. Under this analysis, taxpayers should be pro-ded a tax benefit if other investment income, such as income on a vings account, is used to purchase term insurance protection. lso, if individuals may purchase additional insurance protection ith the previously untaxed investment income of a whole life in-irance policy, then arguably taxpayers should be allowed to educt all or a portion of the cost of term insurance.

Under present law, the owner of a bank certificate of deposit is ibject to tax on the interest income credited annually to the certificate. The same tax treatment applies to certain other forms c investment, the income on which is reinvested (e.g., the purchase c additional shares in a mutual fund). In addition, interest on zer coupon bonds (and other types of original issue discount obliga tions) accrues for tax purposes as it is earned, even though it is nc actually credited to an account for the owner. Taxing the insid buildup of life insurance policies would make life insurance equiva lent for tax purposes to other investments and would reduce a com petitive advantage provided to life insurance companies tha market life insurance as an investment, rather than as economi protection in the event of death.

On the other hand, some may argue that analogizing life insu ance to certificates of deposit or mutual funds fails to recognize th character and importance of permanent life insurance. There ar two components to this argument. First, it is argued that the pu chase of whole life insurance is similar to the purchase of a hom or other capital asset. The appreciation in value of the home o other asset is not taxed until the asset is sold.

This rationale may apply in situations in which the policyholde cannot borrow or otherwise use the earnings on the policy (by as signing or pledging the policy, for example), but is more tenuous i the usual case in which the cash value of the policy can be bo rowed. Life insurance products (other than pure term insuranc have a significant savings component that is comparable in man respects to other financial products. Other financial products ge erally do not receive the same tax-favored treatment (i.e., exclusio or at least deferral of tax on earnings for both the owner of th asset and the financial intermediary providing it) that life insu ance products receive under present law. Thus, to the extent of th similarity in structure and use between life insurance products an other financial products, an argument can be made that it is unfai to exclude inside buildup while taxing income on comparable pro ucts, and the rationable for the exclusion for inside buildup i weakened.

Second, it is argued that only whole life insurance can provid long-term, systematic savings that ensure adequate death benefi protection. Term insurance cannot provide equivalent long-term se curity for the average taxpayer because the term cost of insuranc becomes prohibitively expensive for older policyholders. Only a pe manent program of insurance, it is argued, can build sufficien cash value in the early years after policy issuance to cover th term cost of insurance protection in later years.

2. Is the investment orientation of life insurance limited suffi ciently by the definition of life insurance adopted in the Defi cit Reduction Act of 1984 (DEFRA)?

The definition of life insurance added by DEFRA was intended t reduce the investment orientation of whole life insurance policie In the years before DEFRA, companies began emphasizing invest ment-oriented products that maximized tax deferral. When com pared to traditional life insurance products, these policies offere greater initial investments or higher investment returns. In re sponse, DEFRA provided a definition of life insurance that treate as currently taxable investments those life insurance policies tha

›vide for much larger investments or buildups of cash value than ditional insurance products.

Iowever, the definition of life insurance adopted in DEFRA does limit permissible policies to those that provide a premium pay- nt pattern consistent with traditional forms of life insurance, h as a level premium pattern that continues until the maturity e of the contract. DEFRA allows tax deferred growth for single mium policies as long as the investment component of the icy does not exceed certain parameters set forth in the defini- n. For the more investment-oriented single premium policies on market currently, present law provides a tax subsidy that is re than 300 percent of the value of the life insurance coverage rchased (see Table 5 above).

A basic issue is whether this level of tax-favored investment is tified. The present-law definition of life insurance encourages rchase of single premium life insurance policies by higher ome taxpayers with sufficient disposable income to afford such gle premium contracts. Such a definition provides a greater tax nefit to high income taxpayers and, as such, creates inequities thin the Federal income tax system.

Further, it can be argued that the definition of life insurance ould be tightened in order to ensure that life insurance is pur- ased for death benefit protection and not as an alternative to able forms of investment. Such a tightening of the definition of insurance would reduce the competitive advantage accorded to insurance companies over other financial intermediaries under esent law and would limit the marketing of life insurance as a -favored form of investment.

Life insurance companies point out that purchases of single pre- um life insurance are not limited exclusively to high income tax- yers and that companies permit the purchase of single premium licies with relatively low levels of initial investment. Taxpayers ay have other available assets, such as lump-sum distributions om qualified pension plans, that they wish to use for investment life insurance.

It may be appropriate to review the mechanics of the present-law finition of life insurance for possible abuses even if the funda- ental basis for the DEFRA definition of life insurance is deter- ined to be sound. For example, it may be appropriate to provide at the mortality charges that can be used in calculating whether contract satisfies the definition of life insurance must be based on e mortality charges used in determining the statutory reserve for e contract.

Similarly, it may be appropriate to conform the determination of policyholder's basis for calculating gain in a policy to the deter- ination of basis for calculating loss.

A corollary issue raised by the existence of a life insurance defi- tion that is intended to curb the investment use of life insurance the availability of other tax-favored products not limited by the finition. For example, it can be argued that if the definition of e insurance is tightened to limit investment uses of insurance, in- stors will purchase deferred annuities to obtain tax-deferred side buildup. Deferred annuities are not subject to contribution nits or to nondiscrimination rules as are other retirement vehi-

cles; nor are they specifically required to be used as an investmen
to finance retirement, although present-law distribution rules fo
such annuities are intended to discourage the use of such annuitie
for nonretirement purposes.

Thus, it can be argued that further restrictions on the amount c
investment orientation permissible under life insurance contract
will be ineffective unless corresponding changes are made in th
availability of deferral of tax through a deferred annuity contrac

An argument may be made, however, that the tax treatment c
inside buildup under deferred annuity contracts should not affec
decisions to alter the definition of life insurance because deferre
annuity contracts are subject to less favorable tax treatment upo
partial surrender or withdrawal under present law. It could b
argued, therefore, that the restrictions on withdrawals from de
ferred annuities would serve as a deterrent to investment in suc
annuities even if the definition of life insurance is modified t
reduce the permitted investment orientation.

3. Is access to funds and noninsurance use of inside buildup con sistent with the favorable tax treatment provided unde present law?

It can be argued that whole life insurance and similar product
with cash value (and hence an inside buildup component) do no
achieve their intended purposes under present law because th
amount of the cash value can be borrowed or otherwise withdraw
for other purposes during the insured person's lifetime, and is con
sequently not available to be paid as a death benefit. Thus, on
could argue that the favorable tax treatment accorded to the insid
buildup of a life insurance policy is justified only if the policy i
used for its intended, tax-favored purpose and is not justified if th
policyholder uses inside buildup directly (through partial surren
ders) or indirectly (through loans) for other purposes, such as shor
term investment. Under present law, policyholders receive the ben
efit of tax deferred inside buildup even though the amount se
aside to fund a death benefit is reduced through loans or partia
surrenders.

On the other hand, restrictions on the use of, or accessibility t
the inside buildup of a life insurance policy may deter investment
in such policies and, therefore, may reduce the effectiveness of th
tax incentives created to promote the social policy of providing fo
dependents financially after death.

An argument could be made that withdrawals from life insu
ance policies should be permitted for other socially meritorious ex
penditures (e.g., tuition costs) on a tax-free or at least tax-deferre
basis. For example, although the exclusion for inside buildup ma
not initially have been intended to be used as a tax-free financin
vehicle for college tuition and other educational expenses, its us
as such is not inconsistent with the social policy to encourage edu
cation and, thus, such a use of life insurance should continue to b
permitted.

This reasoning could nevertheless be criticized because colleg
tuition is generally not a deductible or otherwise tax-favored ex
penditure when paid directly, and to treat it more favorably whe
funded indirectly through life insurance merely encourages con

ex transactions, raises form over substance, and primarily benes the well-advised with capital to set aside. Further, the exclun for inside buildup is not targeted to such purposes under esent law, and this use of life insurance was perhaps not an inided consequence of the exclusion.

Should the treatment of contributions, distributions, and loans with respect to life insurance be more consistent with the treatment of tax-favored retirement arrangements?

Present law provides deferral of taxation on investment income rned under certain types of retirement arrangements such as As, qualified pension plans, and deferred annuities (see Table 2 ove). These arrangements, however, are subject to numerous reictions generally designed to ensure that the tax benefit of deferl is targeted to the intended purpose, i.e., to create an incentive saving for post-retirement periods when wage-earners' income rmally decreases significantly. Among the restrictions imposed such retirement arrangements are: (1) restrictions on the nount that can be contributed to fund tax-deferred earnings; (2) ohibition or current taxation of loans; and (3) current taxation of x-deferred earnings that are distributed (including additional xes to take account of the deferral period in the case of early disbutions).

Contributions, distributions, and loans with respect to life insurce products are not subject to these types of limitations under esent law. It can be argued, however, that to the extent that the irpose of permitting tax-free inside buildup is related or comparae to the purpose for providing tax-deferred earnings for retireent arrangements, similar restrictions ought to apply.

The purpose of encouraging people to provide death benefits for eir dependents would be better served if there were disincentives use the cash value of life insurance for other purposes. Thus, it uld be argued that withdrawals and loans—which have the effect reducing the death benefit available to the beneficiary—should ot continue to receive tax-favored treatment, but should be subct to current taxation for the same reason that withdrawals and ans from retirement plans and deferred annuities are taxed. nder this theory, it can be argued that loans under life insurance licies should be treated as distributions, and that distributions iould not be treated as made first from basis.

A counterargument would be that the purpose to provide death enefits is not sufficiently similar to the purpose to encourage the ovision of retirement benefits, and that, therefore, the treatment loans and distributions from retirement vehicles is not appropri-e in the case of life insurance. As a consequence, the present-law x-favored treatment of earnings on life insurance contracts iould be continued even if the taxpayer has current use of the inds.

Drawing a further analogy between life insurance and tax-faored retirement vehicles, it could be argued that limits should be laced on the amount that can be contributed to fund death benets on a tax-favored basis, similar to the contribution limits under etirement vehicles. Such a restriction would inhibit the use of life insurance principally as a savings mechanism for current expend tures of the policyholder that may be unrelated to death benefit and would tend to target the earnings on the life insurance co tract to pay death benefits.

Applying contribution limits to life insurance contracts may b criticized on the grounds that it unreasonably limits the amount the death benefit that individuals may wish to provide for their d pendents.

It can also be argued that comparable contribution limits shou be applied to deferred annuity contracts. Otherwise, without para lel tax treatment, investors who now purchase investment-orient life insurance products would purchase deferred annuities in ord to obtain tax deferral for the maximum amount of investme income.

5. Is the present-law tax treatment of life insurance compani appropriate?

Several arguments support the present-law tax treatment inside buildup on life insurance policies at the company leve First, it can be argued that it is appropriate to allow reserve dedu tions for increases in cash value representing inside buildup on li insurance policies because the cash value approximates the val of the company's current obligation to policyholders. Because t company includes the premium in income as it is received, eve though the benefit is to be paid far in the future (as actuarially d termined), income and deductions are better matched in time, fro a cash flow perspective, if the company can amortize its deducti for the future benefit payment.

This accounting treatment for future liabilities differs fro normal accrual method accounting for tax purposes. Thus, it can b argued that it is not appropriate to permit life insurance comp nies, but not other taxpayers, a deduction for a future liability th has not yet accrued (under the standard "all events" test) and wi respect to which there has not been economic performance (with the meaning of section 461(h)).

This argument acquires additional force in light of the exclusi for the inside buildup at the policyholder level. The overall resu is that in many cases the inside buildup on the policy is nev taxed to the policyholder or the beneficiary, or the life insuran company. Such a result may exceed the tax benefit necessary to e courage the provision of death benefits for dependents.

Nevertheless, the fact that inside buildup is not subject to cu rent taxation at the company level is supported by the argume that the earnings do not really belong to the company. Under th argument, the company, as any other financial intermediary, merely holding and accumulating the funds on behalf of the polic holder and the beneficiary. Thus, it is appropriate that the comp ny not be taxed on income that ultimately belongs to someone els

This argument ignores the fact that, in many cases, the insi buildup is never taxed to anyone. Thus, it could be argued th taxing the inside buildup at the company level would serve as proxy for taxing the inside buildup at the policyholder or benefi ary level.

IV. PROPOSALS TO RESTRICT THE USE OF LIFE INSURANCE AS AN INVESTMENT VEHICLE

A. Policyholder Proposals

1. Treatment of inside buildup under life insurance contracts

ıpose current taxation of inside buildup on all newly issued life insurance and deferred annuity contracts

As set forth in the President's 1985 tax reform proposals,[8] the side buildup on all newly issued life insurance contracts and derred annuity contracts could be currently taxed to the owner of e contract. Under this proposal, the owner of the contract would clude in income for any taxable year any increase during the ar in the amount by which the contract's cash surrender value ceeds the owner's investment in the contract. Special rules could provided for variable contracts in order to prevent taxation of e unrealized appreciation of assets underlying the variable conacts.

ıpose current taxation of inside buildup on newly issued life insurance contracts held by nonnatural persons

The inclusion in income of the inside buildup on newly issued e insurance policies could apply only to policies held by persons her than natural persons. This proposal would conform the treatent of the inside buildup on life insurance policies held by nonıtural persons with the treatment of the inside buildup on derred annuity contracts held by such persons.

imit amount of inside buildup that is not subject to current taxation

As an alternative to imposing current taxation on the entire nount of inside buildup, a limitation could be imposed on the nount of inside buildup for any taxable year that is not subject to ıx. This limitation could be established at a level that would allow policyholder to avoid current tax on the amount of inside buildup ıat would be credited on an ordinary life policy with the same eath benefit or a policy with the same death benefit that provides r level premiums over a specified period, such as 5 or 10 years. nder this alternative, the annual increases in the inside buildup n deferred annuity contracts could be currently includible in ıcome.

A similar result could be achieved by imposing a limitation on ıe annual amount or aggregate lifetime amount that a policyholdr could invest in life insurance contracts and annuity contracts on

[8] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 985), pp. 254-258.

a tax-favored basis. Under this proposal, the inside buildup o amounts invested in excess of the limitation would be subject t current tax.

Treat inside buildup as an item of preference under minimum ta

A more limited approach to imposing current taxation on insid buildup would be to treat all or a portion of the investment incom on newly issued life insurance and deferred annuity contracts as preference item for purposes of the alternative minimum ta rather than merely for purposes of the corporate book income pre erence or the corporate adjusted current earnings preferenc Under this approach, a tax at the rate of 21 percent (20 percent i the case of corporations) would be imposed on a taxpayer subject t the minimum tax on the inside buildup on life insurance contrac that are identified as excessively investment-oriented or on insid buildup in excess of a permitted amount or rate.

2. Definition of life insurance

In general

The statutory definition of life insurance could be narrowed fo newly issued life insurance policies to provide that significantly i vestment-oriented life insurance policies, such as single premiu policies, would not be treated as life insurance for Federal incom tax purposes. If a contract does not satisfy the statutory definitio of life insurance, then the inside buildup under the contract fo any taxable year would be treated as ordinary income received o accrued by the policyholder during the year. In addition, amoun received upon the death of the insured would be excluded from th income of the recipient only to the extent that the amount receive exceeds the net surrender value of the contract.

Require increased insurance protection during 5- or 10-year peri after issuance of contract

The statutory definition of life insurance could be modified to r quire increased insurance protection during the first 5 or 10 yea after the issuance of the contract. One method of accomplishi this result is to limit the amount of premium payments duri each of the first 5 (or 10) years after the issuance of the contract an amount that equals one-fifth (or one-tenth) of the maximu single premium that is allowed under present law for the year th contract is issued.

Thus, under the cash value accumulation test, a contract wou not be treated as a life insurance contract for Federal income ta purposes if the amount of the premium paid for any of the first (or 10) years of the contract exceeded one-fifth (or one-tenth) of th net single premium for the benefits provided in the contract. Sim larly, under the guideline premium requirements, a contract wou not be treated as a life insurance contract for Federal income ta purposes if the amount of the premium paid for any of the first (or 10) years of the contract exceeded one-fifth (or one-tenth) of th guideline single premium for the contract.

Under this premium limitation requirement, a reduction in th benefits under the contract during the first 5 (or 10) years after th uance of the contract would require a recomputation of the ıgle premium for each year preceding the reduction in benefits. addition, rules may be necessary to address increased premium ıyments, reduced future benefits, and other similar modifications the contract that occur after the end of the 5-year (or 10-year) riod.

eatment of mortality charges and expense charges

A further modification to the definition of life insurance would to determine the net single premium, guideline single premium, d guideline level premiums on the basis of the mortality charges tually charged to the policyholder or the mortality charges used determining the statutory reserve for the contract rather than e mortality charges specified in the contract. It is understood at some insurance companies specify excessive mortality charges a contract without actually charging the policyholder for such ıounts in order to increase artificially the amount of the net ıgle premium, guideline single premium, or guideline level pre-iums for the contract. This results in an increase in the allowable sh surrender value under the cash value accumulation test or an crease in the amount of premiums that may be paid under the ideline premium requirements.

In addition, restrictions could be imposed on the amount of ex-nses that are taken into account in applying the guideline premi-n requirements.[9] For example, expenses could be limited to 10 rcent of the mortality charges actually charged to the policyhold- or used in determining the statutory reserve for the contract.

The use of actual mortality charges (or the mortality charges ed in determining the statutory reserve for a contract) and the strictions on expense charges could apply for purposes of deter-ining the limitation on premiums payments during the first 5 (or) years of the contract and/or for purposes of applying the cash ılue accumulation test and the guideline premium require-ents.[10] In either case, rules may be necessary to address inflated ortality or expense charges that are refunded to policyholders.

terest rates used in determining net single premium and guideline premiums

In determining the net single premium for purposes of the cash ılue accumulation test and the guideline premiums for purposes the guideline premium requirement, the interest rate could be ljusted to equal the greater of (1) the applicable Federal rate AFR") in effect on the date that the contract is issued, or (2) the ıte guaranteed on issuance of the contract. The AFR is currently sed to calculate life insurance reserves, as well as for other inter-t imputation purposes.

[9] The expenses of issuing and maintaining a life insurance contract are not taken into ac-ınt in determining the net single premium of the contract, and, consequently, such expenses not affect the allowable cash surrender value under the cash value accumulation test.

[10] If the mortality charges used in determining the statutory reserve for a contract and the ıitation on expense charges are required to be used for purposes of applying the cash value cumulation test and the guideline premium requirements, the premium that could be charged any life insurance contract would be statutorily capped.

Treatment of variable contracts

Any contract that provides a return that is based on the current investment return or current market value of a segregated asset account (i.e., a variable contract) could be excluded from the definition of life insurance. Alternatively, variable life insurance contracts could be excluded from the definition of life insurance if the policyholder is permitted to elect different investment options after the issuance of the contract.

GAO proposal relating to the treatment of loans in defining life insurance

In a recent report on the taxation of single premium life insurance, the General Accounting Office (GAO) suggested a change to the statutory definition of life insurance. "[11] GAO proposed that the cash value corridor be modified for single premium contracts by reducing the amount of the death benefit by the amount of any loan outstanding under the contract. Because the minimum death benefit under a life insurance contract must exceed a specified percentage of the cash surrender value under the contract in order to satisfy the cash value corridor, the GAO proposal generally should limit the ability of policyholders to borrow against single premium contracts.[12]

3. Treatment of pre-death distributions from life insurance contracts

Description of H.R. 3441

H.R. 3441 (introduced by Messrs. Stark and Gradison on October 7, 1987) would alter the Federal income tax treatment of loans and other pre-death distributions from life insurance contracts to conform the treatment of distributions from life insurance contracts to the treatment of distributions from annuity contracts prior to the annuity starting date. Under the bill, distributions from life insurance contracts would be treated as income first and then as recovery of basis.[13] In addition, loans under life insurance contracts (including pledges and assignments of contracts) would be treated as distributions that are subject to the new basis ordering rule.[14] Finally, an additional 10-percent income tax would be imposed on the portion of any distribution or loan under a life insurance contract that is includible in income. This early withdrawal tax would not

[11] United States General Accounting Office, Briefing Report to the Honorable Fortney H. (Pete) Stark, House of Representatives: *Tax Policy, Taxation of Single Premium Life Insurance* (GAO/GGD-88-9BR), October 1987. As an alternative to the change to the statutory definition of life insurance, GAO suggested that loans under single premium contracts be treated as distributions. This alternative is summarized below in "3. Treatment of pre-death distributions from life insurance contracts."

[12] The principal reason for this result is that the GAO proposal does not reduce the cash surrender value under the contract by the amount of the loan. Under present law, neither the cash surrender value nor the death benefit is reduced by policyholder loans in determining whether a contract falls within the cash value corridor.

[13] Policyholder dividends under newly issued life insurance contracts generally would be subject to the new basis recovery rule. An exception to the new rule would be provided for policyholder dividends that are retained by the insurance company as a premium or other consideration paid for the contract. This exception is consistent with the present-law treatment of policyholder dividends under annuity contracts.

[14] H.R. 3441 also provides that a transfer of an insurance contract for less than full value would be taxable under the same rule that currently applies to annuity contracts.

ply if a distribution occurs (1) after the holder of the contract at-ns age 59-1/2; (2) on account of the holder's disability; or (3) as t of an annuity-type distribution over the holder's life expectan-

I.R. 3441 would apply to loans and other pre-death distributions t occur after October 7, 1987 (the date of introduction of the), but only to the extent that the amount distributed is allocable premiums paid on or after such date.

nit application of H.R. 3441 to specific contracts

he provisions of H.R. 3441 could be limited to a specific class of tracts that are considered to be heavily investment-oriented. example, the reversal of the basis ordering rule, the treatment oans as distributions, and the imposition of the early withdraw-ax could be limited to contracts under which the amount of pre-ums paid during any of the first 5 (or 10) years after the issu-e of the contract exceed one-fifth (or one-tenth) of the maximum gle premium allowed under present law. Alternatively, the icter distributional rules could apply to a specific class of invest-nt-oriented contracts for a limited period of time after the issu-e of any such contract.

O proposal relating to the treatment of loans as distributions

n its recent report on the taxation of single premium life insur-e,[15] GAO suggested that policyholder loans be treated in the ne manner as distributions under annuity contracts. Thus, the ount of a policyholder loan would be includible in gross income the extent that the cash surrender value of the contract immedi-ly before the loan exceeds the investment in the contract at h time. It is unclear whether the GAO alternative would change basis ordering rule for other pre-death distributions from life urance contracts.[16]

her possible proposals relating to loans and partial surrenders

The treatment of policyholder loans and partial surrenders der H.R. 3441 would be consistent with the treatment of loans d partial surrenders under annuity contracts. As an alternative, ns and partial surrenders under life insurance contracts could treated in the same manner as loans and early distributions m qualified pension, profit-sharing, or stock bonus plans.

Under present law, a loan from a qualified pension, profit-shar-g, or stock bonus plan generally is treated as a taxable distribu-n from the plan to the extent that (1) the loan exceeds a speci-d amount (the lesser of $50,000 or one-half of the participant's crued benefit) or (2) the time for repayment exceeds 5 years. In e case of a pre-annuity starting date distribution from a qualified nsion, profit-sharing, or stock bonus plan, part of the distribution considered basis recovery and the remainder is income.

[15] *See* note 11, *supra.*

[16] The GAO proposal indicates that if policyholder loans are treated in the same manner as ributions under annuity contracts, loans or *distributions from income* would be treated as able income in the year withdrawn.

Policyholder loans could alternatively be treated as below-marke loans that are subject to the rules of section 7872. Under this pro posal, the policyholder would be treated as (1) paying a market rat of interest on the loan to the insurance company, and (2) receivin a dividend from the insurance company equal to the amount o deemed interest.[17]

Finally, additional restrictions could be imposed on the deduct ibility of interest on indebtedness that is incurred with respect t life insurance policies. For example, interest on indebtedness tha is incurred with respect to life insurance contracts could be treate as nondeductible (as is the case for interest on indebtedness that i incurred or continued to purchase or carry tax-exempt obligations Under this approach, borrowing against the cash value of a policy a pledge or assignment of the policy, and borrowings to acquire o maintain the policy would result in nondeductible interest.

Alternatively, the present-law limit on the deductibility of inte est in the case of indebtedness exceeding $50,000 per officer or em ployee of, or person financially interested in, any trade or busines carried on by the taxpayer could be decreased or an overall cap (i addition to the present limit) could be placed on the amount of de ductible interest or allowable indebtedness.

Reduction of investment in contract by cost of term insurance

As proposed by the President in his tax reform proposals o 1985,[18] a policyholder's basis (or investment in a contract) could b reduced by the aggregate cost of renewable term insurance provi ed under the contract. Consequently, under this proposal, polic holders would be unable to obtain the equivalent of a deduction fo the cost of current insurance protection, which is generally regar ed as a personal expense.[19]

4. Combination of definitional and distributional approaches

A combination of the definitional and distributional approach could also be applied. Under this alternative, contracts that a considered abusive would not qualify as life insurance, and, thu the inside buildup would be taxed currently to the policyholde Contracts that are not considered abusive but are considered exce sively investment oriented would be subject to stricter distributio al rules, such as basis reordering, the treatment of loans as dist butions, and the 10-percent additional income tax. All other co tracts would continue to be governed by present law.

B. Insurance Company Proposals

The use of life insurance as an investment vehicle could also curtailed by changing the tax treatment of life insurance com

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[17] Absent a change in the basis ordering rule, this alternative would have minimal effec the use of policyholder loans because the deemed policyholder dividend would not be inclu in income by the policyholder unless the dividend exceeded the policyholder's investment i contract.

[18] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May , pp. 254-258.

[19] In determining the amount of any loss from the complete surrender of a life insur contract, the cost of insurance protection is not included in basis. *London Shoe Co., Inc.*, 80 230 (2nd Cir. 1935); *Century Wood Preserving Co.*, 69 F.2d 967 (3rd Cir. 1934).

ɪs. Under present law, the amount of the reserve for any life in-
ance contract may not be less than the amount credited to the
h value of the contract. Because a life insurance company is al-
ved a deduction for increases in reserves, the life insurance com-
ny is not subject to tax on the inside buildup that is credited to
policy.

eatment of reserves

One method of addressing this issue at the life insurance compa-
level (as opposed to the policyholder level) would be to deny the
urance company a reserve deduction for all newly issued life in-
ance contracts. Under this proposal, an insurance company
uld be allowed a deduction for death benefits only as the bene-
are actually paid. Thus, the investment income on life insur-
ce contracts would be subject to current tax at the life insurance
npany level.

Similarly, a portion of the inside buildup on investment-oriented
ntracts could be taxed to the insurance company by limiting the
erve for any contract to the amount of the reserve that would be
owed for a contract with the same death benefit if the contract
s funded on a level basis over a specified period, such as 5 or 10
ars. Similarly, the provision of a loan could be taxed to the insur-
ce company by requiring the insurance company to reduce its re-
ve for any contract by the amount of any loan outstanding
der the contract.

Alternatively, life insurance companies could be treated in the
me manner as other financial intermediaries (such as banks)
th respect to deposits. Under this alternative, the receipt of pre-
um income that is credited to the cash surrender value of a con-
ct would be excluded from the gross income of the life insurance
mpany and only the excess of the death benefit over the cash
rrender value would be allowed as a deduction to the life insur-
ce company when the death benefit is paid.

ternative minimum tax treatment

Another approach would be to disallow deductions for life insur-
ce reserves in computing the corporate minimum tax. Under this
proach, reserve deductions for newly issued policies would not be
rmitted in calculating an insurance company's alternative mini-
um taxable income, with the result that the inside buildup on
ose policies issued by an insurance company subject to the mini-
um tax would be subject to tax at the corporate alternative mini-
um tax rate of 20 percent.

finitional approach to life insurance reserves

The present-law definition of life insurance (or a modified ver-
n of it) could be applied at the insurance company level. That is,
reserve would be permitted with respect to a contract that fails
meet the definition of life insurance.

V. ANALYSIS OF PROPOSALS TO RESTRICT THE USE O LIFE INSURANCE AS AN INVESTMENT VEHICLE

Taxation of inside buildup

The proposal to tax the inside buildup on all newly issued insurance contracts is considered by many to be an overly b approach to limiting the use of life insurance as an investment hicle. Under such an approach, the inside buildup on ordinary insurance and other extended premium payment policies would subject to current tax, although historically these policies have been purchased for the purpose of sheltering investment earni It is argued that the taxation of the inside buildup on all life in ance contracts would significantly reduce the amount of life in ance that is purchased and, thus, many dependents would be with an inadequate source of income upon the death of the insu

On the other hand, it may be considered appropriate to tax inside buildup if the insurance is not purchased for the purpos providing for death benefits for dependents, regardless of the of premium payments under the contract. For example, many porations and other businesses purchase life insurance on the l of employees solely as a tax-free or tax-deferred investment to f liabilities under nonqualified deferred compensation plans or o similar liabilities. The ability of taxpayers to use life insuranc fund liabilities arising under nonqualified deferred compensa plans creates a disincentive to establish qualified plans, wl must cover rank-and-file employees in addition to officers other highly-compensated employees in order to satisfy nondisc ination requirements.

Others would counter that providing death benefits for depe ents is not the sole justification for favorable tax treatment of insurance contracts and that corporations and other busine have legitimate, nontax reasons for insuring the lives of key ployees of the business. It may be argued that purchases of life surance should be encouraged to preserve the stability of busin es (particularly small businesses). Further, banks and other fi cial institutions will often require the purchase of key emplo life insurance as collateral before lending to a corporation or o business.

If it is determined that the purchase of whole life insura should be encouraged by providing favorable treatment of inside buildup but that such treatment should not be available higher-income taxpayers who use life insurance as a tax-shelte investment, it may be appropriate to impose an annual or lifet cap on the amount that may be invested in life insurance and ferred annuity contracts on a tax-favored basis. Alternatively, cluding the inside buildup on life insurance as an item of tax p erence for purposes of the alternative minimum tax also would ct the ability of higher-income taxpayers to shelter investment nings without adversely affecting other taxpayers.

'inition of life insurance

'he principal argument in support of proposals to modify the sent-law definition of life insurance to require increased insur- :e protection during the initial years of a life insurance contract hat such proposals affect life insurance contracts that are con- ɜred to be overly investment-oriented, rather all life insurance tracts. In addition, a modification to the definition of life insur- :e that reduces the amount of the premium that is available for estment purposes is likely to discourage the sale of life insur- :e as a tax-sheltered investment rather than as a means to pro- e death benefits.

)n the other hand, the definitional approach may be more com- x than the other alternatives and may be susceptible to manipu- on. For example, the present-law cash value accumulation test l the guideline premium requirements have been manipulated certain aggressive life insurance companies through the use of ated mortality and expense charges that are never actually ırged to the policyholder.

\ further element of complexity in a definitional approach that hibits the purchase of single premium life insurance is present- by various features of life insurance that might be characterized single premium life insurance. For example, an exchange of one insurance contract for another could be viewed as a purchase single premium life insurance. In addition, purchases of paid-up litions with policyholder dividends is, in essence, the purchase of litional insurance coverage with a single premium payment.

Even if it is determined that increased insurance protection need be required during the initial years of an insurance contract, it y be appropriate to clarify the present-law definition of life in- 'ance to address inflated mortality and expense charges.

However, a practical problem is presented by a proposal to ad- ss the issue of overstated mortality and expense charges. Fre- ɜntly, a life insurance company will reserve the right to reduce rtality or other stated charges if the company's experience is re favorable than was assumed. A proposal to require the use of ual mortality and expense charges would eliminate the flexibil- of companies to retrospectively readjust their stated charges. In lition, such a proposal might create additional complexity by re- ring annual retesting of all life insurance contracts in which the ted charges have not been applied. An alternative that may ve more administrable might be to permit readjustments within ermissible range of the mortality and expense charges stated in ontract.

'urther, care would be required to prevent the definitional limits life insurance from operating as price restraints. For example, actual expenses associated with certain types of life insurance tracts may differ greatly from the expenses associated with ıer types of whole life insurance. A definitional rule that limits expense charges may operate to create price restraints for poli- s that actually generate greater expense charges than the limit.

Treatment of pre-death distributions

Proposals for the reversal of the basis ordering rules, the tre ment of loans as distributions, or the imposition of a 10-perce early withdrawal tax for certain pre-death distributions under l insurance contracts may be subject to criticism for inadequat targeting policies that are overly investment oriented. It is c tended by some that present law should continue to apply with spect to insurance contracts that provide a significant amount insurance protection. Based on this argument, only those contra that are defined as overly investment oriented would be subject the stricter distribution rules.

Other opponents contend that the distributional approach wo not curtail the sale of single premium and other heavily inve ment-oriented life insurance contracts because there is a sign cant tax advantage in the compounding of investment earnings a tax-free basis that would not be recaptured if the distribut occurs a significant period of time after the issuance of the c tract. Instead, it is believed that the focus should be on the amo of money that may be allocated to the cash value of a life ins ance contract in relation to the amount of insurance protect provided under the contract.

Those opposing changes to the treatment of loans under life surance contracts argue that policyholder loans should not treated differently from other loans secured by property that l appreciated in value. For example, a taxpayer is not treated as alizing gain on a house that has appreciated in value if the taxp er borrows money using the equity in the house as collateral the loan.

The principal argument in favor of the distributional approacl that it would prevent policyholders from gaining ready access tax-free investment income and, thus, should ensure that life ins ance contracts are being purchased to provide death benefits for pendents rather than for other financial purposes. In addition, distributional approach generally is consistent with the present-l treatment of distributions from qualified pension plans and an ity contracts. If the distribution rules applicable to life insura remain more favorable than the rules applicable to qualified p sion plans, employers will continue to have an incentive to est lish nonqualified deferred compensation plans that cover o highly compensated employees.

An additional argument in favor of treating loans as distri tions is that in most instances the policyholder is not obligated repay the amount borrowed. Ordinarily, the loan is satisfied by ducing the amount payable upon surrender of the contract or reducing the benefit payable to beneficiaries upon death.

Treatment of life insurance companies

It can be argued that the taxation of life insurance companies the inside buildup on life insurance contracts is likely to be m administrable than taxing the policyholders directly. In additi such an approach ensures that the inside buildup does not c pletely escape income taxation, which ordinarily occurs if a life surance policy is held until the death of the insured.

'n the other hand, the taxation of life insurance companies on de buildup is inconsistent with the Federal income tax treat- ıt of other financial intermediaries, such as banks, mutual ds, and real estate investment trusts. Under present law, finan- intermediaries generally are not required to include in taxable ›me the amount of investment earnings that are credited or oth- ise set apart for their customers. These investment earnings, /ever, generally are taxable to the customers of the financial in- nediaries for the taxable year in which credited or otherwise set rt.

O