[JOINT COMMITTEE PRINT]

DESCRIPTION OF PROVISIONS OF S. 1992 RELATING TO LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JANUARY 31, 1984

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for January 31, 1984, on the provisions of S. 1992,[1] the Life Insurance Tax Act of 1983 (introduced by Senators Bentsen, Chafee, Moynihan, Danforth, Boren, Grassley, Wallop, Durenberger, Bradley, and Mitchell), relating to the tax treatment of individuals. These provisions relate to (1) the definition of life insurance, (2) the treatment of variable annuity or life insurance contracts, (3) the treatment of distributions from annuities, (4) the deductibility of interest on policyholder loans, (5) the taxation of group-term life insurance benefits, and (6) the allowance of nondeductible contributions to individual retirement plans.

The first part of the pamphlet is a summary. This is followed in the second part by a more detailed description of present law and the provisions of S. 1992 relating to the treatment of life insurance products and policyholders and to the allowance of nondeductible contributions to individual retirement plans.

[1] The provisions of S. 1992 are identical to the provisions of Title II of H.R. 4170, which was reported by the House Committee on Ways and Means on October 21, 1983 (H. Rep. No. 98-432).

I. SUMMARY

S. 1992 would affect the tax treatment of individuals in six specific areas.

First, the bill would provide a comprehensive definition of life insurance for tax purposes. Under present law, a policyholder is not taxed on the investment earnings of a life insurance contract unless the policy is surrendered or matures prior to the death of the insured. The bill would provide for current taxation of the investment portion of certain investment-oriented contracts currently being sold as life insurance. Generally, these contracts would be those that allow for a substantial investment of cash as premiums or permit an accumulation of income as a cash surrender value that is excessive relative to the insurance risk under the contract.

Second, present law provides for taxation at the company level on capital gains realized on assets held for variable annuity contracts. In contrast, in the case of a variable life insurance contract, capital gains are taxed only to the contractholder, and then only if the contract is surrendered or matures prior to the death of the insured. Under the bill, the rules for variable annuities would be extended for variable life insurance contracts.

Third, present law imposes a 5-percent penalty on premature distributions from deferred annuity contracts. Generally, a distribution is premature if made before the annuitant attains age 59½; however, an exception applies to distributions of income allocable to investments made at least 10 years before the distribution. The bill would delete this exception. Also, under the bill, if the holder of a deferred annuity dies before the annuity starting date, the undistributed income would be taxed to the decedent-annuity holder in the taxable year ending with the annuity holder's death.

Fourth, present law allows policyholders to deduct interest paid on loans secured by the cash surrender value of life insurance except in certain specific abuse cases. Under these rules, it is possible to purchase life insurance protection in such a way that the combination of tax-free build-up of the cash surrender value and deduction of interest on the borrowing of that cash surrender value produces a positive after-tax return to the policyholder. The bill would limit the amount of interest that could be deducted with respect to loans secured by the cash surrender value of life insurance. This limitation would be equal to the product of the tax deficiency rate times $250,000 ($500,000 in the case of life insurance held in connection with a trade or business).

Fifth, under present law, the value of group-term life insurance protection provided to employees is excluded from the employees' income subject to a $50,000 limitation. Also, the exclusion is not available with respect to discriminatory plans. The bill would apply the $50,000 limitation and the nondiscrimination rules to group-term life insurance coverage provided to retired employees.

Sixth, under present law, contributions to individual retirement accounts are limited to those that are deductible for income tax purposes. The bill would permit nondeductibie contributions of up to $1,750 per year.

II. DESCRIPTION OF PROVISIONS OF S. 1992

A. Definition of Life Insurance Contract

Present Law

Generally, there is no comprehensive definition of a life insurance contract that applies for all tax purposes. A life insurance contract is defined for purposes of section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.

Income earned on the cash surrender value of a life insurance contract is not taxed currently to the policyholder, but is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract. The investment in the contract at any date is the aggregate amount of premiums and other consideration paid for the contract to date, less any amount returned or received under the contract that was excluded from gross income. No adjustment is made to the investment in the contract to account for the cost of the current life insurance protection received under the contract to such date. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

This special tax treatment has been accorded to life insurance products because, arguably, an adequately insured work force contributes to the general economic welfare. However, in recent years, insurers have seemed to emphasize the tax-advantaged treatment in designing products. This raises the question of whether some products are being sold (and bought) primarily as investment vehicles, with the provision of a death benefit being the secondary consideration.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life contracts) qualify as life insurance contracts for purposes of the exclusion of death benefits from income. The guidelines apply to contracts issued in 1982 and 1983. They were adopted to ensure that products similar to level-premium whole life insurance contracts or other traditional products would receive comparable tax treatment. At the same time, Congress sought to deny traditional tax treatment to other investment-oriented products which provide for the accumulation of large amounts of cash surrender value and a relatively small amount of pure insurance protection.

Violation of the guidelines at any time during the contract will cause the contract to be treated as providing a combination of term

life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines, death proceeds from flexible premium lie insurance contracts are treated as life insurance if either of two tests is met.

Alternative 1

Under the first of the two tests, a contract qualifies if:

(a) the sum of the premiums paid for the benefits at any time does not exceed the greater of the net single premium (based on a 6-percent interest rate) or the sum of the net level premiums (based on a 4-percent interest rate), assuming the policy matures no earlier than in 20 years or at age 95 (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year thereafter to 105 percent at age 76 or older.

Alternative 2

Under the second of the two tests, a contract qualifies if the cash surrender value does not exceed the net single premium (based on a 4-percent interest rate) for the amount payable at death, assuming the policy matures no earlier than in 20 years or at age 95 (if earlier).

Explanation of Provision

The bill would provide a definition of a life insurance contract for purposes of the Internal Revenue Code. Rules that are similar to those contained in the temporary provisions of TEFRA would be extended to all life insurance contracts. Like the temporary provisions, the proposed definition would restrict the use of new investment-oriented products as life insurance. In addition, some traditional products currently sold as life insurance, but which allow the accumulation of a substantial amount of cash value with a comparatively small amount of pure insurance protection, would no longer be treated as life insurance.

Definition of life insurance

A life insurance contract would be defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternative tests: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium limitation and a cash value corridor. In the case of variable life insurance contracts, the determination of whether the contract meets either of these tests would be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period.

Cash value accumulation test

The first alternative test under which a contract could qualify as a life insurance contract would be the cash value accumulation test. This test would allow traditional whole life policies with cash values that accumulate based on interest rates of 4 percent or greater to continue to qualify as life insurance contracts. Certain contracts traditionally sold by life insurance companies, such as endowment contracts maturing earlier than age 95, would not continue to be classified as life insurance contracts because of their innate investment orientation (i.e., the accumulation of large amounts of cash surrender value relative to the amount of pure insurance protection).

Under this test, the cash surrender value of the contract could not, by the terms of the contract, at any time exceed the net single premium which would have to be paid at that time in order to fund the future benefits under the contract, assuming the contract matures no earlier than age 95 for the insured. The term future benefits under the bill means death benefits and endowment benefits. Generally, the death benefit is the amount that is payable in the event of the death of the insured. Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder would be entitled upon surrender and against which the policyholder generally could borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend.

The reasonable or unreasonable nature of a termination dividend might be determined by reference to the historical practice of the industry. For example, New York State prescribes a maximum termination dividend of $35 per $1,000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest would not be part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. Likewise, amounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt would not be considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

Whether a contract is a life insurance contract under this test would be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium would be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. Because the definitional test refers to the cash surrender value, the rate guaranteed on the issuance of the contract would be that reflected in the contract's nonforfeiture values. With respect to variable contracts that may not have a guaranteed rate, then the 4-percent rate would apply. The mortality charges taken into account in computing the net single premium would be those specified in the contract or, if none are specified

in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefits would not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit would be treated as a future benefit, thereby increasing the allowable cash value accumulation by the discounted value of such charge. For life insurance contracts, qualified additional benefits would be guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit would be taken into account. For example, if a contract provides for annual business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance would be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second test under which a contract could qualify as a life insurance contract would impose two requirements:. the guideline premium limitation and the cash value corridor. The guideline premium portion of the test would distinguish between contracts under which the policyholder makes traditional levels of investment through premium payments and those which involve greater investments by the policyholder. The second requirement, the cash value corridor, would disqualify contracts that build up excessive amounts of cash value (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements would tend to limit the benefits of life insurance treatment to contracts that have premiums, investment levels, and investment returns that reflect an insurance as well as an investment orientation. At the same time, these requirements still would allow investment returns, and tax deferral thereon, that exceed the amount necessary to fund the specified future benefits of the contract.

The specifics of these requirements are described below.

Guideline premium requirements

A life insurance contract would meet the guideline premium limitation of the second test if the the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract would be the premium at the date of issue required to fund the future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the minimum rate or rates guaranteed on the issuance of the contract. The guideline level premium would be 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 would 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, if it is established to the satisfaction of the Secretary that the requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary could waive the first requirement. Premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirements would be treated as a reduction of the premiums paid during the year. The interest paid on such return premiums would be includible in gross income. This "hold harmless" provision in the event of a timely correction is comparable to similar provisions elsewhere in the Code.

Cash value corridor

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

As the following table shows, the applicable percentage to determine the minimum death benefit would start at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage would decrease 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 would decrease by the same amount for each year in that 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 would be 142.

The statutory table of applicable percentages follows.

In the case of an insured with an attained age as of the beginning of the contract year of:		*The applicable percentage 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

The applicable percentages under the temporary provisions of present law phase down (ratably and annually) from 140 percent for ages up to 40 years to 105 percent at age 76 and older. In comparison, the proposed percentages generally would restrict the accumulation of cash value more than the percentages in the temporary provisions, but still would allow more generous cash value accumulation than would occur under a traditional policy. Because the proposed phase-down occurs at different rates over the various age intervals, the proposed percentages would tend to provide for accumulation at a greater rate for ages 55 and older than for earlier ages.

Computation of benefits

The bill would provide three general computational rules. These rules are directed, generally, at preventing insurance companies from avoiding the definitional limitations by creative product design. First, in computing the benefits under any contract, the death benefit would be deemed not to increase at any time during the life of the contract (qualified additional benefits would be treated in the same way). Thus, a contract could not assume a death benefit that is level, then decreases, only to increase again, in order to allow earlier funding of an increased future benefit, and still satisfy the premium guideline limitation. Second, the maturity date would be deemed to be no earlier than the day on which the insured attains age 95. This rule generally would prevent contracts endowing before age 95 from qualifying as life insurance. Third, the amount of any endowment benefit, or the sum of any endowment benefits, would be deemed not to exceed the least amount payable as a death benefit at any future time under the contract.

Notwithstanding the first computational rule, an increase in the death benefit that is provided in the contract, and which is limited to the amount necessary to prevent a decrease in the excess of the death benefit over the cash surrender value, could be taken into account for purposes of meeting the two definitional tests provided under the bill. Specifically, for a contract qualifying under the guideline premium requirement, this type of increasing death benefit could be taken into account in computing the guideline level premium. Thus, in such a case, the premium limitation would be the greater of the guideline single premium computed by assuming a nonincreasing death benefit or the sum of the guideline level premiums computed by assuming an increasing death benefit. In the case of a contract qualifying under the cash value accumulation

test, the above described increasing death benefit could be taken into account if the cash surrender value of the contract could exceed at any time the net level reserve. For this purpose, the net level reserve would be determined as though level annual premiums were paid for the contract until the insured attains age 95. These modifications to the computational rules would allow the sale of contracts with limited increases in death benefits, for example, where the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

Adjustments

Changes in the terms of a contract might occur at the behest of the company or the policyholder, or by the passage of time. In the event of such changes, the limitations under the alternative tests would be recomputed, treating the date of change as a new date of issue. Thus, if the future benefits were increased because of a scheduled change in death benefit (other that an increase resulting from the crediting of excess interest) or the purchase of paid-up additions, such changes would require an adjustment and recomputation of the definitional limitations. Under the bill, the Secretary of the Treasury would have authority to prescribe regulations governing how such recomputations should be made. Further, there is a special provision that any change in the terms of a contract that would reduce the future benefits under the contract shall be treated as an exchange of contracts (under sec. 1035), and so may give rise to a distribution taxable to the policyholder.

Contracts not meeting the life insurance definition

If a life insurance contract fails to meet either of the alternative tests, the income on the contract for any taxable year of the policyholder would be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract for any taxable year would be the amount by which the sum of the increase in the net surrender value of the contract and the cost of life insurance protection provided exceeds the amount of the premiums paid reduced by the amount of any policyholder dividends distributed during the year. Because the income on the contract would be treated as received by the policyholder, presumably the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance).

Under the bill, the income on the disqualified contract for all prior taxable years would be treated as received or accrued during the taxable year in which the life insurance contract ceases to meet the definition of a life insurance contract. The cost of life insurance protection provided under any contract would be the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

Death benefits paid under a disqualified contract would not be entitled to the same exclusion from income as benefits paid under a qualifying contract. Only the excess of the amount of death benefit paid over the net surrender value of the contract would be treat-

ed as paid under a life insurance contract and excluded from the beneficiary's income.

If a life insurance contract fails to meet the tests in the definition, it would, nonetheless, be treated as an insurance contract for company tax purposes. This ensures that the premiums and income credited to failing policies would continue to be taken into account by the insurance company in computing its taxable income.

Effective Date

General effective date

Generally, the new definition of life insurance would apply to contracts issued after December 31, 1983. Contracts issued in exchange for existing contracts after December 31, 1983, would be considered new contracts issued after that date.[1]

Transition rules

Contracts issued during 1984.—Any insurance contract that is issued during 1984 would be treated as meeting the definitional requirements of a life insurance contract if the contract meets: (1) the requirements of the temporary provisions enacted in TEFRA, or (2) for a contract that is not a flexible premium life insurance contract (defined under Sec. 101(f)), the requirements set forth in the bill by substituting 3 percent for 4 percent as the minimum interest rate to be used in applying the cash value accumulation test.

Contracts issued pursuant to existing plans of insurance.—Under another transition rule, certain "qualified contracts" under existing plans of insurance would qualify as life insurance contracts under the cash value accumulation test if the contracts would meet the test using 3 percent, instead of 4 percent, as the minimum interest rate. A "qualified contract" would be any contract that requires at least 20 level annual premium payments and is issued pursuant to any plan of insurance which has been filed by the issuing company in one or more States before September 28, 1983. Presumably, the 20-pay requirement would not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract.

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[1] It is unclear whether a reduction in death benefits (which would be a change in future benefits requiring an adjustment and recomputation of the definitional limits, and which would be treated as an exchange of contracts under the adjustment provisions) would be considered an exchange under this provision also.

B. Variable Annuities and Variable Life Insurance

Present Law

In general, either a variable annuity [2] or a variable life insurance contract is a contract under which any amounts or premiums received are invested in a separate asset account of the insurance company, and the amounts paid in or paid out reflect the investment return and the market value of such separate account. Under a variable annuity, either the cash surrender value before the annuity starting date or annuity payments made after the annuity starting date (or both) would reflect the investment activity of the separate account; under a variable life insurance contract, the cash surrender value and the amount of death benefit would fluctuate with the investment activity of the separate account. Because the contract benefits can fluctuate and a particular investment return is not guaranteed by the insurance company, the contractholder can be said to bear the investment risk under the contract.[3]

In addition to the definitional concern that the tax benefits of life insurance products should not be given to contracts that are too investment oriented, the sale of variable contracts (both annuity and life insurance) raises the additional issue of whether competitive equity investment vehicles enjoy, under present law, the same status for tax purposes. For example, one might look through the purchase of a variable insurance contract, viewing it rather as the purchase of a share in a mutual fund.[4] Despite the similarity of their investment returns, there can be substantive differences between the individual tax treatment of a variable contract sold by an insurance company and that of a share in a mutual fund. An owner of a mutual fund share is taxed currently on the ordinary and capital gain income of the mutual fund. Likewise, the transfer from shares in one fund for shares in another can give rise to capital gain income. In contrast, under a variable contract based by a separate account issued by an insurance company, the tax on the income of the fund that is credited to the policyholder is deferred. Further, under section 1035, gain on an exchange of life insurance contacts or annuity contracts [5] is generally not recognized. On the

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[2] The term variable annuity will be used generally to refer to a contract which reflects the investment activity of a company and also a contract that reflects the investment return and market value of a segregated asset account within a company, although the latter may be referred to more specifically as "a contract with reserves based on a segregated asset account." See sec. 801(g).

[3] Generally, a certain minimum death benefit will be guaranteed by the insurance company. Thus, to the extent there is a minimum death benefit, the company bears the investment risk.

[4] Both variable annuities and variable life insurance are securities subject to the Securities Act of 1933. For a specific discussion concerning this classification, for variable annuities, *see* SEC V., *Variable Life insurance Company of America*, 359 U.S. 65 (1959).

[5] Code sec. 1035 provides that no gain or loss is recognized on the exchange of (1) a life insurance contract for another life insurance contract, an endowment contract or an annuity contract; (2) an endowment contract for another comparable contract or an annuity contract; or (3) an annuity contract for an annuity contract.

other hand, gain on the sale by a mutual fund of a capital asset retains its character in the hands of an individual owner of a mutual fund share. In contrast, gain on the sale by an insurance company of an asset held in a segregated asset account is taxed to a holder of a variable contract on distribution at ordinary income rates.

Generally, income on an annuity contract is taxed only once, at the policyholder level when the income is distributed. This is accomplished by means of a deduction at the company level for amounts credited to policyholders under annuity contracts. However, under present law, income on nonqualified variable annuity (i.e., one that is not purchased as part of a qualified pension plan) may be taxed at the company level as well as at the policyholder level. Under present law, amounts credited to the holder of a nonqualified variable annuity based on appreciation in the value of the separate asset account are not deductible by the company. Thus, under present law, the company pays a tax at a capital gains rate on the sale of an appreciated asset, without an offsetting value of the separate account assets are not deductible by the company. Thus, under present law, the company pays a tax at a capital gains rate on the sale of the appreciated asset, without an offsetting deduction for the income credited to the contract- holder. When the income is distributed, it is taxable as ordinary income to the contractholder. The result is that amounts credited to a variable annuity that reflect the appreciation in value of assets in the separate account are taxed once at the company level at the capital gains rate and once to the contractholder as ordinary income. This double tax occurrence was recognized as appropriate in 1959 and again in 1962,[6] although it was eliminated for qualified pension contracts in 1962.

The provisions above do not cover the newer variable life insurance contracts. In the case of such accounts, there is no company level tax on amounts credited to contractholders that reflect the appreciation of the assets in the underlying separate account. Further, the company is allowed an ordinary deduction for such appreciation, whether realized or unrealized, when it is credited to the variable life insurance contract (and is reflected in reserves or the cash surrender value) and is taxed at the capital gains rate on the appreciation income when it is realized upon sale of the asset. As with other life insurance contracts, the policyholder will only be taxed on the income credited to the contract upon surrender to the extent the cash surrender value exceeds the investment in the contract (i.e., aggregate premiums paid, less any returned premiums, with no adjustment made for the cost of the current insurance protection received before surrender); if the contract terminates with the insured's death, the death proceeds are excluded from the gross income of the beneficiary.

Explanation of Provision

The bill retains the rules under present law that are applicable to variable annuities and extends those rules to apply variable life

[6] S. Rep. 291, 86th Cong., 1st Sess. 36 (1959); and S. Rep. 2109, 87th Cong. 2d Sess. 7-8 (1962).

insurance contracts. Through an adjustment in the company's reserve deduction for variable contracts, any capital gain that is realized and reflected in the benefits under a variable annuity contract or a variable life insurance policy would be taxed at the company level before enjoying the usual tax treatment at the policyholder level. It could be argued that the proposal equalizes the tax treatment of insurance products based on investment funds and direct investment in such funds. In the case of "pension plan contracts" (i.e., contracts that are issued as part of a qualified pension plan), the company level capital gains tax is eliminated as it was under present law.

Effective Date

The provision would apply to taxable years beginning after December 31, 1983.

C. Treatment of Distributions from Annuity Contracts

Present Law

An annuity contract issued by a life insurance company is a promise to pay to the beneficiary a given sum for a specified period, which period may terminate at death.[7] Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income. The insurance company takes the risk that such amount will be exhausted before the company's liability under the contract ends, but gains if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the accumulation period.

An individual may purchase an annuity by payment of a single premium or by making multiple premium payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

The taxation of interest or other current earnings on a contractholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Each amount paid to a contractholder as an annuity is treated in part as a distribution of income on the contract and, in part, as a nontaxable return of capital. In contrast to annuity payments, policy dividends paid after annuity payments begin are taxable in full to the contractholder as ordinary income.

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract.[8] A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contractholder attains age 59½, when the

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[7] If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is generally a variable annuity contract.

[8] Under prior law, amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract, were first treated as a return of the policyholder's capital and were taxable (as ordinary income) only after all of the policyholder's investment in the contract had been recovered.

contractholder becomes disabled, upon the death of the contractholder, or as a payment under an annuity for life or for at least 5 years. Tax on the income that has accumulated under the annuity contract is deferred until there is a distribution of income, and the recipient of an annuity contract on the death of the contractholder stands in the shoes of the deceased contractholder, with the same investment in the contract.

Explanation of Provision

Penalty on premature distributions

The bill generally would retain the present-law provisions for annuity contracts. However, the 5-percent penalty on premature distributions (whether as a partial surrender, a cash withdrawal, or an annuity for less than 5 years) would apply to any amount distributed to the taxpayer before the age of 59½. The bill would impose the penalty tax without regard to whether the distribution is allocable to an investment made within the preceding 10 years.

The bill would limit the tax deferral benefits available to annuity holders on a basis that is more comparable to other sanctioned retirement savings programs, (*e.g.*, IRAs). The proposed repeal of the 10-year rule would be consistent with IRA plan rules under which distributions before age 59½ are subject to a penalty tax (although the penalty rate is 5 percent instead of 10 percent). As a result, emphasis is placed on annuities as a form of long-term or retirement savings to provide a taxpayer with an income that avoids the risk of his outliving the accumulation of assets.

Distributions or withdrawals from an IRA or redemption of retirement bonds are included in gross income for the year in which the distribution occurs. In addition, the amount of the distribution or withdrawals is subject to a 10-percent penalty tax if the distribution or withdrawal occurs before the individual on whose behalf the IRA was established attains age 59½. Premature distributions from an annuity, in contrast, are subject to a penalty tax of 5 percent—which is one-half of the 10-percent penalty tax on distribution from an IRA. The contribution or investment in a deferred annuity is made from after-tax income, but the $2,000 contribution to an IRA is tax-deductible.

The following table and explanatory discussion compares the after-tax investment return enjoyed by investors in savings accounts, IRAs, and deferred annuities, for taxpayers in 20-, 35-, and 50-percent marginal tax brackets. One may conclude from the table that the penalty tax can operate to discourage early withdrawals from a deferred annuity, but the deterrent effect is relatively short-lived, i.e., 5 to 7 years; there is no penalty tax on withdrawals if the taxpayer begins contributing to the annuity 5 or so years before the planned distribution date.[9]

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[9] Table 1 was developed to illustrate the effect of the penalty tax on premature withdrawals, and the interest rate assumptions may not reflect the relative interest rate structure of the assets that may be purchased currently by investors in these forms of savings. In addition, the tax-free benefits of an IRA are allowable on deposits up to only $2,000 a year.

TABLE 1.—YIELDS ON $2,000 PRE-TAX INVESTMENT IN ALTERNATIVE SAVINGS INSTRUMENTS AFTER TAX AND STATUTORY PENALTIES; 20, 35 AND 50 PERCENT MARGINAL TAX RATES

Year	20% marginal tax rates			35% marginal tax rates			50% marginal tax rates		
	Savings account	I.R.A.	Deferred annuity	Savings account	I.R.A.	Deferred annuity	Savings account	I.R.A	Deferred annuity
1	$1,754	$1,568	$1,744	$1,401	$1,232	$1,394	$1,062	$896	$1,054
2	1,922	1,756	1,905	1,511	1,380	1,499	1,127	1,004	1,114
3	2,107	1,967	2,086	1,629	1,546	1,616	1,197	1,124	1,182
4	2,309	2,203	2,288	1,756	1,731	1,748	1,271	1,259	1,258
5	2,531	2,468	2,515	1,893	[1] 1,939	[1] 1,895	1,350	[1] 1,410	1,343
6	2,774	2,764	2,768	2,041	2,171	2,060	1,433	1,579	[1]1,438
7	3,040	[1] 3,095	[1] 3,053	2,200	2,432	2,244	1,522	1,768	1,545

[1] In all subsequent years, benefits from tax deferral accruing before withdrawal provide after-tax yields greater than after-tax yields on savings account.

Statutory penalties on premature withdrawal of tax-deferred income accruals are 5 percent from deferred annuities and 10 percent from I.R.A.'s.

12 percent rate of interest compounded annually.

No deferral on savings accounts. Initial deposit and earnings of IRA tax deferred until withdrawal. Initial deposit after-tax in deferred annuity, interest tax deferred until withdrawal.

Generally, a taxpayer who has been making contributions to an IRA or a deferred annuity will be better off after 5 to 7 years by taking a premature distribution and paying income and penalty taxes than he would be by depositing the initial $2,000 less income tax in a savings account or another bank investment on which interest would be taxable currently. The tax advantages outweigh the penalty in 5 years for a 50-percent marginal rate taxpayer with an IRA and in 7 years for a 20-percent marginal rate IRA owner. Before then, the accruals in a deferred annuity are similar to those of an IRA but yield a somewhat smaller after-tax advantage.

The investment of $2,000 is reduced by the applicable marginal income tax rate at the beginning of the first year, and the remainder is contributed to a deferred annuity or a savings account. The $2,000 deposit in the IRA is made tax-free. The interest income (assumed at 12 percent and compounded annually in each case) of the savings account is taxed at the end of the year when credited to the savings account. Tax is deferred on the interest income of the deferred annuity and the IRA until an early withdrawal is made, and at that time the appropriate marginal tax rate is applied to the total deferred income and the 5-percent (deferred annuity) or 10-percent (IRA) penalty tax for premature withdrawal also is levied.

Distribution in event of annuity holder's death

In the case of a contract other than a contract issued under a qualified plan, if the owner of the contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract would be treated as paid to the contractholder immediately before death. Thus, the income in the contract would be subject to income tax in the decedent's return for the year of death. In order to avoid taxing the income on the contract twice, the amount includible in gross income of the decedent would be treated as a premium paid for the contract, giving the new owner a step-up in basis or additional investment in the contract. The 5-percent penalty tax on a premature distribution from an annuity would not apply to any amount includible in gross income because of the deemed distribution in the event of the contractholder's death. Thus, the bill would shift the incidence of the income tax on the income accumulated in a deferred annuity from the surviving beneficiary to the decedent contractholder.

This provision, in effect, reverses the income in respect of a decedent rules that would otherwise apply. Under income-in-respect-of-a-decedent rules, if a decedent taxpayer has earned income but such income is not received and includible in income prior to his death, the taxpayer who inherits the right to the income payment stands in the shoes of the decedent and includes it in income when received. Thus, the taxpayer who actually receives the income pays the tax thereon. Arguably, the reversal of the income-in-respect-of-a-decedent rules in this case may (in some situations) prevent the shifting of income from a high tax-bracket individual to an individual with a lower marginal tax bracket, as well as prevent the indefinite postponement of the payment of tax on accrued income.

The proposed treatment of annuity contracts upon death before the annuity starting date would differ also from that given, for ex-

ample, to IRAs. Under present law, if the owner of an IRA account dies before distributions have commenced, the income in the account is taxable to the beneficiary under the following restrictions: (1) if the beneficiary is a spouse, the IRA account (together with tax deferral) can be continued until distributions must be commenced for the spouse; or (2) if the beneficiary is not the decedent's spouse, the account must be distributed within 5 years. The continued tax deferral for the spousal beneficiary recognizes that retirement savings may be intended to be used as retirement income for the married couple, while the limited continuation of tax deferral for nonspousal beneficiaries requires immediate recognition of some of the income while avoiding an unreasonable bunching of income in a single year.

D. Policyholder Loans

Present Law

Generally, taxpayers are allowed to deduct interest paid or accrued on indebtedness during the taxable year. However, no deduction is allowed for interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Similarly, no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract.[10] If substantially all the premiums on a contract are paid within 4 years of the date on which the contract was purchased, the contract is treated as if it were a single premium contract. Further, if a purchaser borrows an amount equal to a substantial portion of the premium payments on a contract and deposits the borrowed funds with an insurance company to fund future payments on the policy, the purchaser is treated as having acquired a single premium contract.

The present law limitations on the deductibility of interest on debt incurred to purchase or carry certain life insurance products have their origins in the 1942 Revenue Act. Congress felt that the opportunity under prior law to combine the tax-free build-up of investment income in a life insurance policy and the current deduction of interest on indebtedness incurred or continued to purchase or carry the policy constituted a "considerable loophole" that could yield substantial tax advantages.[11] For example, if an individual purchased a single premium policy, borrowing all or a substantial part of the funds necessary to pay the premium on the policy, the annual increase in the cash value of the policy, apart from the premiums, could equal or exceed the net interest expense incurred by the purchaser. Where the annual increment in value of the policy exceeded the net interest cost of the borrowing, ownership of the policy could actually result in a net profit. In this environment, insurance companies were actually issuing policies under plans which contemplated that the taxpayer would borrow the premiums either directly from the insurer, or from a bank or other lender, and marketing these policies primarily on the basis that the policies were tax-saving devices.

In response, Congress enacted a provision to deny interest deductions with respect to indebtedness incurred or continued to pur-

[10] Sec. 264(a)(1) also provides that no deduction shall be allowed for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

[11] H.Rep. 2333, 77th Cong., 2d Sess. 47 (1942).

chase a single premium life insurance or endowment contract. These limitations were extended in 1964 to preclude the deduction of interest on indebtedness incurred or continued to purchase or carry insurance pursuant to a plan of purchase that contemplates systematic borrowing. These changes resulted from a concern that policies were being sold to high bracket taxpayers who could afford to acquire large whole-life policies on the basis that the policies cost the individual little or nothing, and in some cases on the basis that the policies actually result in a net profit.[12]

The importance of being able to borrow on insurance for other than tax-avoidance purposes was recognized, however, and Congress provided several exceptions to the rules disallowing the interest deduction. Under these provisions, a deduction is allowed if (1) no part of 4 of the first 7 annual premium payments due under the contract is paid by means of indebtedness; (2) the total of the amounts paid or accrued during the taxable year does not exceed $100; (3) the amount was paid or accrued on indebtedness incurred because of an unforeseen substantial increase in financial obligations; or (4) the indebtedness was incurred in connection with the taxpayer's trade or business. Under present law, if the requirements of any one of these 4 exceptions are satisfied, a taxpayer can deduct the full amount of interest otherwise deductible on an unlimited amount of indebtedness.

The 4-out-of-7 rule was designed to disallow the interest deduction in the case of a plan of systematic borrowing unless the loan proceeds were required for use in the taxpayer's business. However, current marketing techniques indicate that goal may not have been achieved. The result has been that the 4-out-of-7 rule provides a safe harbor under which it is still possible to sell policies on the basis of the tax savings that can be generated from the purchase of a policy, followed by the systematic direct or indirect borrowing of a substantial part of the increases in the cash value of such policy.

The following table is based on the structure of a policy that has actually been marketed and illustrates the advantages that can be obtained in combining tax-free inside buildup and maximum borrowings. An industry expert has indicated that this policy was designed for a 50 year old male using the 1980 CSO mortality table and a 4 percent assumed interest rate. The contract would endow at age 100. Given these assumptions, the contract would qualify as a life insurance contract under the provisions of S. 1992.

[12] H.Rep. 749, 88th Cong., 1st Sess. 61 (1963); S.Rep. 830, 88th Cong., 2d Sess. 77-78 (1964).

TABLE 2.—ILLUSTRATION OF $500,000 PERMANENT LIFE INSURANCE PURCHASED FOR A 50 YEAR OLD MALE WITH MAXIMUM BORROWING AND DIVIDENDS USED TO BUY PAID-UP ADDITIONS

Year	Net after tax outlay	Cum. net after tax outlay	Annual loan	Loan interest at 10.3%	Cumulative loan	Net equity at surrender	Net death benefit	Guaranteed cash value
1	$14,454	$14,454	0	0	0	$280	$500,689	0
2	14,454	28,908	0	0	0	10,686	502,826	$9,500
3	745	29,654	$14,454	$1,489	$14,454	8,981	492,329	20,500
4	1,489	31,143	14,454	2,978	28,908	8,210	483,691	31,500
5	2,233	33,376	14,454	4,466	43,363	8,947	476,930	43,000
6	16,687	50,063	0	4,466	43,363	25,287	486,563	54,500
7	16,687	66,751	0	4,466	43,363	42,837	498,160	66,000
8	−35,394	31,357	54,910	10,122	98,272	8,356	458,554	77,500
9	807	32,164	19,724	12,154	117,996	11,175	456,522	89,500
10	730	32,895	20,876	14,304	138,871	13,908	455,608	101,000
20	−7,934	−6,507	47,082	49,387	479,487	44,348	475,581	217,500
30	−20,683	−154,953	97,079	123,864	1,202,559	94,078	536,856	319,500
40	−36,438	−438,887	185,363	268,940	2,611,069	182,915	614,939	397,500

Under this policy, a death benefit of $500,000 was provided and dividends were assumed, in the illustrations, to buy paid-up additions. The annual premium for a 50-year-old male was priced at $14,454 and maximum borrowing provided for in all but the first, second, sixth and seventh years. The issuer of the policy projected that the annual net after-tax cost of the policy would be in the $14,000 to $17,000 range in 4 of the first 7 years and below $2,300 in each of the other 3 years. After the eighth year, there would be no significant cost to the policyholder in continuing the policy. Starting in the eleventh year, the policyholder would experience a positive cash flow from the policy in every year. This occurs because the added amount that the policyholder may borrow from the increasing cash value of the policy exceeds the premium charges and the after-tax cost of the interest payable on the loan balance in those years. Beginning in the twentieth year, the policyholder's cumulative after-tax net outlay would be negative. Finally, if the policyholder were to die at age 80, the insurer's projections show a cumulative positive after-tax benefit to the policyholder over the 30 years of $155,000 and a net death benefit of close to $540,000. In that event, the policyholder would have realized a 12-percent net after-tax rate of return on the premiums invested in the policy.

Explanation of Provision

The bill would amend present law by adding a limitation on the amount of interest that is deductible. Amounts that are not deductible under present law would continue to be nondeductible under the bill.

The applicable limits

Individual policyholders and businesses owning policies insuring the lives of individuals would be allowed to deduct, for any taxable year, a limited amount of life insurance interest for such taxable year. Life insurance interest would be defined as interest paid or accrued in connection with a life insurance loan. A life insurance loan is any indebtedness if (1) the interest paid or accrued with respect to such indebtedness would, but for this provision, be deductible; and (2) the indebtedness is (a) incurred under, or secured by, a life insurance, endowment or annuity contract, or (b) incurred or continued to purchase or carry a life insurance, endowment or annuity contract. Thus, the provisions for limiting the deduction of interest under section 264 and under this bill would apply whether the loan is from the insurance company or a third party.

The amount that an individual policyholder could deduct in any taxable year (the applicable limit) would be equal to the product of $250,000 ($500,000 in the case of a joint return) multiplied by the interest rate for deficiencies (prescribed under sec. 6621) in effect as of the first day of the taxable year. The applicable limit for a business is the product of $500,000 multiplied by the deficiency interest rate for each insured that is treated under the bill as a qualified life.

Business taxpayers

For purposes of this provision, the $500,000 business limitation would apply to corporations, partnerships, proprietorships, or other entities engaged in a trade or business. As suggested above, businesses could deduct interest subject to an aggregate limitation based on the number of qualified lives.

Qualified lives are defined in the bill by reference to the amount of coverage provided an insured as a percentage of the maximum amount provided under other policies owned by the business. Under the bill, a qualified life would be an individual insured under a life insurance policy owned by a corporation, partnership, proprietorship or other entity engaged in a trade or business if (1) at some time during the taxable year the life of the individual is insured under a whole life policy owned by the business, and (2) the face amount of such policy is at least as great as 10 percent of the highest face amount of any whole life policy owned by the business and insuring the life of any other individual. Thus, if a corporation owns policies insuring the lives of three individuals, and the face amount of two of the policies is $1 million and the face amount of the other is $50,000, the individual with respect to whom the $50,000 policy is held would not be a qualified life. In such event, the corporation would be subject to an interest limitation of $1 million times the appropriate deficiency interest rate.

Carryover of unused limitation

Any excess limitation could be carried over and added to the limitation for the succeeding taxable year. Thus, if for any taxable year a taxpayer failed to pay or incur and deduct an amount of interest equal to the maximum deductible amount, the excess of the maximum amount over the amount that is deducted could be added to the maximum deductible amount for the succeeding taxable year. For example, assume that in a particular taxable year a individual not engaged in a trade or business borrows $10,000 at 8 percent and pays and deducts $800 of interest. If the deficiency rate under section 6621 for that year is 11 percent, the individual's unused interest limitation would be $26,700 (i.e., 250,000 X .11 - $800). If the deficiency rate is the same the next year, the individual's limitation for the next taxable year would be $54,200, (26,700 + ($250,000 X .11)) The unused amounts would carry over indefinitely. In reporting an identical provision, the Ways and Means Committee stated that no carryover would arise, however, with respect to a year in which there are no outstanding life insurance loans to the taxpayer or if the loans are on policies not covered by the new provisions adopted by the bill. Presumably, also the applicable limits described above apply regardless of the face amount or the cash surrender value of the policies (i.e., the applicable limit for an individual would be $250,000 multiplied by the deficiency interest rate even for a $10,000 face amount policy or for a policy with an available cash surrender value of $5,000).

Effective Date

The provisions of the bill relating to the deduction of life insurance interest would apply with respect to interest paid or accrued

in taxable years ending after September 27, 1983. The provisions would not apply, however, to any indebtedness incurred under, secured by, or incurred or continued to purchase or carry a life insurance, endowment or annuity contract if such contract was issued before September 28, 1983, or was issued on or after such date pursuant to a binding contract entered into before such date.

E. Treatment of Group-term Life Insurance (Sec. 79)

Present Law

Employers often provide an amount of group-term life insurance protection to their employees as a fringe benefit. Such coverage is typically provided either as a fixed amount for each covered employee or as a set percentage or multiple of annual compensation for each covered employee. Some plans may provide for lesser or greater coverage for retired employees or may omit coverage of retired employees. Frequently, employees and retirees will be permitted to elect group-term life insurance coverage or other benefits.

Prior to the Revenue Act of 1964, the value of group-term life insurance provided by an employer for an employee was excluded from income by the employee. The exclusion of the value of group-term life insurance resulted from Treasury regulations rather than from a statutory mandate.[13] The Treasury justified this exclusion on the grounds that (1) the group-term coverage benefited the employee's beneficiaries rather than the employee, and (2) the benefits were characterized as contingent on the continuation of the employment relationship.[14]

In 1964, Congress determined that the tax-free receipt of group-term life insurance protection provided an employee with a substantial economic benefit and represented compensation that should be included in an employee's income. The 1964 Act, however, provided two major exceptions to this rule under which the cost of group-term life insurance coverage remained excluded from an employee's income. First, an exclusion was provided for the cost of up to $50,000 of group-term coverage. This exclusion was provided to encourage employers to provide basic life insurance protection to their employees. In addition, the absence of any transition rules in the 1964 Act suggests that the $50,000 limitation may have been intended to protect, indirectly, most then existing plans from the reach of the new limitations. The second major exception provided under the 1964 Act allowed retired employees to exclude all group-term coverage from income. This exception appears to have arisen out of a concern that an employee, who is no longer working, lacks a sufficient ability to pay tax on these benefits. This concern is also evidenced by the lack of transitional rules in 1964 Act.[15]

In TEFRA, Congress amended the group-term life insurance rules to deny the $50,000 exclusion when protection for key employees is provided under a discriminatory plan. However, because the nondiscrimination rules were drafted as a limitation on the

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[13] No comparable exclusion from income was ever provided for individual insurance or for cash value life insurance provided to employees.

[14] L.O. 1014, 2 C.B. 88 (1920).

[15] Exceptions were also provided for coverage under which the employer or a charity was designated as the beneficiary.

$50,000 exclusion, the rules do not affect group-term life insurance protection provided to retired employees.

These nondiscrimination rules provide that the income exclusion for employer-provided group-term life insurance applies with respect to a key employee only if the life insurance is provided under a program of the employer that does not discriminate in favor of key employees as to (1) eligibility to participate, or (2) the life insurance benefits provided under the plan.

A program of an employer providing group-term life insurance for employees generally is not considered to discriminate in favor of key employees as to eligibility to participate if (1) the program benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the program benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees. Alternatively, a program of an employer providing group-term life insurance which is provided under a cafeteria plan is not considered to discriminate in favor of key employees as to eligibility to participate if the eligibility rules for cafeteria plans are satisfied. Certain employees may be excluded when testing for nondiscrimination.

A program of employer-provided group-term life insurance for employees is not considered to discriminate in favor of key employees as to the benefits provided, if the program does not discriminate in favor of such employees with regard to the type and amount of the benefits. For this purpose, group-term life insurance benefits are not considered to discriminate merely because the amount of life insurance provided employees bears a uniform relationship to compensation.

When the cost of group-term life insurance coverage is includible in the income of an employee, that cost is determined on the basis of uniform premiums prescribed by the Treasury for 5-year age brackets ranging from age 30 to age 64. For employees age 64 and over, the age 59 to 63 cost is applied. The most recent premium costs prescribed by the Treasury are:

5-year age bracket	Cost per $1,000 of protection for 1-month period
Under 30	$0.08
30 to 34	.09
35 to 39	.11
40 to 44	.17
45 to 49	.29
50 to 54	.48
55 to 59	.75
60 to 64	1.17

Thus, an employee age 50 who receives $100,000 of group-term coverage recognizes $ 288 of income (50 x $0.48 per thousand of excess insurance x 12 months).

The social benefit of having an employer provide a minimum amount of life insurance coverage for wage earners on a nondiscriminatory basis may, in practice, not be achieved. For example, under present law, group-term insurance plans may be used as a means of withdrawing profits from a business by, or the building of an estate for, a retiring owner-employee. Likewise, a large amount of term life insurance provided under a group plan can be the basis of a nontaxable deferred compensation plan for key employees.

Explanation of Provision

The bill would effect three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also would apply to retired as well as active employees.[16] The amendments would not alter the cost tables, however, so a retired employee's benefit would be computed at the age 65 cost.

Second, the nondiscrimination rules would be applied to plans covering retired employees. Thus, the cost of group-term coverage that is provided only to retiring key employees would not be subject to any exclusion from gross income. Third, under the bill, if a plan fails to qualify for the exclusion because it is discriminatory, then the employees and retirees would have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury.

Unless a plan is discriminatory, under the bill's provisions, a retired employee's benefit would be computed on the basis of the uniform cost tables. At age 65 the cost is presently $1.17 per thousand of excess insurance. Thus, a retiree age 65 who receives $100,000 of group-term coverage would recognize $702 of income which would have a maximum tax effect of $351. By contrast, the rate schedules of one major company set the premium for $100,000 of individual term coverage for a 65-year old male in excess of $3,000 per year.

Effective Date

The changes in the group-term life insurance rules made by the bill would not apply to any group-term life insurance plan in existence on September 27, 1983, with respect to covered individuals and to the extent of their coverage. Although on its face this provision grandfathers existing plans, several questions are left unanswered. For example, what would constitute a change in plan so that the resulting changed plan would not be considered to be in existence on September 27, 1983? Would an increase in coverage be a change in plans? Individuals coverage by the plan are grandfathered to the extent of their coverage: is that their present coverage as an active employee or the amount of coverage guaranteed to them upon retirement under the plan? Is the amount of grandfathered coverage limited to the present numerical amount coverage or would a coverage formula be grandfathered?

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[16] The bill would not apply the limitation to those who have terminated employment because of a disability.

F. Nondeductible Contributions to Individual Retirement Plans

Present Law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year generally is the lesser of 100 percent of compensation (generally net earnings from self-employment in the case of a self-employed individual) for the year or $2,000. The $2,000 contribution limit is increased to $2,250 for a year if (1) at least $250 is contributed to an IRA for the spouse of the employee, and (2) the spouse has no compensation for the year. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA.

An annual excise tax applies to prohibited nondeductible contributions (*i.e.*, excess contributions) held in an IRA. The tax is 6 percent of the balance of the nondeductible contributions. Under present law, an individual is allowed a deduction from gross income for a taxable year if the individual corrects an excess contribution for a previous year by contributing less than the maximum amount allowable as a deduction for the year.[17]

Under present law, an individual is permitted to make a rollover contribution of a distribution from an IRA to another IRA without including the amount of the distribution in gross income. A tax-free rollover is generally allowed if the rollover occurs within 60 days after the date of the distribution. An individual is allowed to make a rollover contribution from an IRA once each year. Rollover contributions are not treated as excess contributions to an IRA and do not reduce the allowable deduction for a taxable year.

Income and gain on amounts held in an IRA are not taxed until distributed. Except in the case of certain correcting distributions or distributions rolled over to another eligible plan, all distributions from IRAs are includible in gross income when received. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax. If an individual borrows from an IRA or uses IRA amounts as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70½, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for certain exclusions under the estate and gift tax rules.

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[17] The rule allowing a deduction for prior year contributions applies only to the amount of the excess contributions that do not exceed (1) the maximum allowable deduction for the year minus (2) the amounts contributed for the year.

Present law requires that the trustee or issuer of an IRA make annual calendar year reports relating to the status of the IRA.[18] This report must contain the following information for transactions during the calendar year: (1) the amount of contributions; (2) the amount of distributions; (3) in the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance; (4) the name and address of the trustee or issuer; and (5) such other information as the Commissioner may require. The annual report must be provided (1) to the individual on whose behalf the account is established or in whose name the annuity is purchased, and (2) to the Internal Revenue Service.

Explanation of Provision

In general

Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) would not be treated as excess contributions subject to the 6-percent annual excise tax. The nondeductible limit for a taxable year would be the least of (1) $1,750, (2) the excess of compensation includible in the individual's gross income for the year over the amount allowable as a deduction under the IRA rules, or (3) the amount of designated nondeductible contributions for the year.

Under the provision, a designated nondeductible contribution would be any contribution to an IRA for a taxable year that the individual designates as a nondeductible contribution, up to the nondeductible limit. The designation could be made or revoked up to the day prescribed by law for filing the income tax return for the taxable year, including any extensions of time for filing to which the individual is entitled.

In any case in which nondeductible contributions are made on behalf of an individual and an individual's noncompensated spouse (within the meaning of the spousal IRA rules), the nondeductible limit for the taxable year could be allocated in any manner. For example, an individual could make contributions of $875 as designated nondeductible contributions to the individual's IRA, and contributions of $875 as designated nondeductible contributions to the spousal IRA for the individual's noncompensated spouse. Alternatively, contributions of $1,750 of designated nondeductible contributions could be made to the spousal IRA.

Annual IRA contributions that exceed the sum of the amount allowable as a deduction for the taxable year and the nondeductible limit would be treated as excess contributions that are subject to the annual 6-percent excise tax. Under the provision, if contributions in a later taxable year, are less than the sum of (1) the amount allowable as a deduction for the taxable year, and (2) the nondeductible limit, excess contributions from the prior year could be applied against the remaining amount allowable as a deduction and the remaining nondeductible limit in the same manner as under present law. A designated nondeductible contribution could not, however, be recharacterized as a deductible contribution after

[18] Treas. Reg. § 1.408-5.

the time for filing the tax return for the taxable year of the contribution (including extensions).

Under the bill's provisions, any amount paid or distributed from an IRA would be treated, first, as paid or distributed from income and gain allocable to designated nondeductible contributions (to the extent thereof), second, as paid or distributed out of designated nondeductible contributions (to the extent thereof), and, third, out of other amounts. If an IRA distribution includes cash and property other than cash, the amount distributed would be the fair market value of the property plus the amount of cash distributed. If appreciated property is distributed, the gain allocable to designated nondeductible contributions would include the unrealized appreciation.

In general, any amount paid or distributed from an IRA is included in the gross income of the individual for the taxable year in which the payment or distribution is received. Amounts that are treated as paid or distributed out of designated nondeductible contributions, however, would be treated as a return of basis and would be excluded from gross income. Similar rules would apply to distributions under an individual retirement annuity and, therefore, the general rules relating to the taxation of distributions under individual retirement annuity contracts would be inapplicable.

For example, an individual's IRA could have accumulated designated nondeductible contributions of $10,000, income of $1,000 attributable to the designated nondeductible contributions, and other allowable amounts equal to $20,000. If the individual withdraws $15,000 from the IRA during a taxable year, $1,000 would be treated as coming from the income attributable to designated nondeductible contributions, $10,000 as attributable to the designated nondeductible contributions, and $4,000 as attributable to other allowable IRA contributions and income. The balance of designated nondeductible contributions under the IRA would be zero after the distribution. In this case, the individual would include $5,000 in gross income for the taxable year (*i.e.*, $15,000 minus $10,000 treated as a return of basis). In addition, if the withdrawal occurs prior to the time the individual attains age 59½, dies, or becomes disabled, $5,000 (the amount includible in gross income) is subject to the additional 10-percent income tax on premature distributions.

Recordkeeping and reporting requirements

The provision would permit both nondeductible and deductible contributions to be made to a single IRA. However, to ensure that the character of the contributions is retained, special recordkeeping and reporting provisions would apply.

One such provision would require an individual to designate the amount of nondeductible IRA contributions for a year. This designation could be required to be made to the trustee or issuer accepting the nondeductible contributions to aid the trustee or issuer in maintaining the records that would be required relating to the character of the amounts contributed. This designation would also assist the trustee or issuer in complying with the reporting requirements of the provision and with the annual reporting requirements of present law. With respect to the annual reporting requirement,

the financial institution, when reporting contributions to IRAs, would specify the portion of any contribution that is a designated nondeductible contribution.

Under the provision, the individual's designation must be made not later than the time prescribed for filing an income tax return (including extensions). In order to assist the financial institution in maintaining records and meeting reporting requirements, the trustee or issuer would specify a date by which the designation must be made.

In addition, the provision would require the trustee or issuer of an IRA to maintain any records necessary to account separately for designated nondeductible contributions and for the income and gain attributable to designated nondeductible contributions. Under regulations prescribed by the Secretary of the Treasury, amounts rolled over, tax-free, from one IRA to another IRA would be required to be reported in a manner that would retain the character of the amounts as designated nondeductible contributions, income on designated nondeductible contributions, or other amounts.

Treasury regulations could require that the trustee or issuer of an IRA would provide a report to the individual on whose behalf an account is established or in whose name an annuity is purchased. This report could be provided to the individual at the time a payment or distribution is made from the IRA and could contain information relating to the character (*i.e.*, designated nondeductible contributions, income attributable to designated nondeductible contributions, and other amounts) of the amounts paid or distributed. In addition, a copy of this report could be required to be supplied to the trustee or issuer of an IRA to which a rollover contribution from another IRA is made so that the character of the amounts rolled over would be retained. Similarly, if a trustee-to-trustee transfer of IRA funds is made, any information relating to the character of the amounts transferred could be required to be supplied to the new trustee or issuer.

The report supplied at the time of a payment or distribution from an IRA would be required to be provided in addition to, and not in lieu of, the annual report required under present law.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1983.

Revenue Effect

It is estimated that this provision of the bill would reduce budget receipts as follows (for fiscal years 1984-1988):

[In millions of dollars]

1984	1985	1986	1987	1988
−15	−66	−141	−227	−321

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