NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

Tax Reform, Tax Expenditures, Insurance & Annuities

The Issue: As Washington grapples with budget deficits and how to make the tax code more pro-growth and internationally competitive, "tax expenditures" have become a hot topic on both sides of the aisle. Generally, tax expenditures result in the deferral, reduction, or elimination of tax liability that would otherwise apply were it not for "special" tax code rules. The Joint Committee on Taxation has labeled the current tax treatment of permanent life insurance as a tax expenditure where the cash value grows to exceed the sum of premiums paid. This "inside buildup" is a function of contracts that allow policyholders to pre-pay for life insurance that would otherwise rise sharply in cost in later years, and the insurance company invests the "excess" premiums to provide policyholders with the time value of their money. Generally, the combination of premiums paid over the life the contract plus investment results equals the death benefit at the contract's maturity date.

The present budget realities and focus on tax expenditures endanger the tax rules applicable to the insurance and annuity products that NAIFA members use every day to help secure long-range financial security for ***2 out of 3 American families***. Yet there are important economic, social, and tax policy reasons for the present tax treatment of insurance and annuities. If American families and employers are discouraged from these savings – a virtually certain result of imposing current tax liability on annual increases in policy values – ultimately it likely would have a larger negative impact on public budgets than the nominal size of the tax expenditure scores.

Background: The fundamental tax treatment of insurance dates back to 1913, when the first income tax was enacted. At that time, Congress began fashioning a tax structure that encouraged individuals, and later businesses, to transfer certain financial risks to life insurance and annuities. Insurance and annuities are generally purchased with after-tax dollars, and policy owners pay ordinary income tax on policy gains whenever there is a withdrawal or surrender. This tax policy has been reviewed several times over the last century, and each time Congress has chosen to preserve the current tax treatment, for good reasons.

- ***Insurance and annuity products allow Americans to transfer financial risk*** dependents face at the death (or disability) of a breadwinner, the risks businesses (associates or employees) face at the loss of a key person in the business, or the risk to individuals and their families of outliving accumulated retirement savings. This pooling and transfer of risk to insurers protects not only individuals and private business, but also government entitlement programs such as Medicaid and food stamps that otherwise would be called upon to lessen the impact of the loss of income.

  Current tax policy recognizes the social and budgetary value of this type of risk transfer by allowing employers some limited opportunities to provide term life insurance, retirement annuities, disability insurance and long-term care insurance to their employees on a pre-tax basis. Most life insurance and annuities are purchased with after-tax dollars, however. Raising taxes on these products would increase their costs and discourage Americans from this beneficial transfer of risk.

- ***Permanent life insurance and annuities are major sources of long-term investment capital.*** Twenty percent of long-term savings in the U.S. is found in permanent life insurance and annuities. Thus, these

long-term savings vehicles not only secure the financial future of individuals, they also provide critical fuel for growing the American economy, including jobs and infrastructure.

- ***Raising taxes on insurance and annuities would be "penny wise and pound foolish."*** Higher taxes on insurance and annuity products would inevitably discourage and reduce their purchase. The consequence of less insurance and annuities would be slower economic growth and greater liabilities for government entitlement programs, resulting in a negative budgetary impact likely to far outweigh the nominal increase in revenues estimated from increased taxes on these products.

- ***Deferral of tax liability on "inside buildup" is consistent with general taxation principles.*** The Joint Committee on Taxation's annual estimates for tax expenditures state the principle that "the deferral of tax until realization is not classified as a tax expenditure." Just as the owners of stocks or real estate do not pay tax on their appreciation until these investments are sold, owners of life insurance and annuities pay tax on appreciation when their ownership interest in these policies is fully or partially surrendered. The main difference is that insurance and annuity gains are taxed at *higher* ordinary income rates whenever they are realized. (The lower tax rate on dividends and capital gains *is* classified as a tax expenditure.)

  Though permanent life insurance policies create a savings aspect ("cash value"), policyholders generally cannot access the cash value without giving up important insurance protection. (Replacement insurance generally becomes more expensive as a person ages, and the person may even become uninsurable.) Because inside buildup usually is not accessible without losing the significant value of insurance protection guaranteed at the current premium rate, it is not realized or constructively received, and therefore should not be taxed unless and until there is a full or partial surrender of the policy. This is the case under current law.

  Unlike life insurance, annuities are designed to generate regular income, and earnings *are* taxed, as soon as distributions are made, at ordinary income rates (plus a 3.8% surtax for high income recipients beginning in 2013). But similar to life insurance, accelerated access to accumulated savings is subject to substantial withdrawal restrictions or penalties, so these amounts are not constructively received.

NAIFA Position: The tax code should not create disincentives for long-term savings and risk-shifting. Congress should reaffirm the current tax rules to encourage individuals to put and keep money aside in permanent life insurance and annuities, as well as to replace income and protect retirement savings with disability income and long-term care insurance. These vehicles guarantee long-range financial security to families and businesses, and also benefit the national budget and economy.

About NAIFA: Founded in 1890 as the National Association of Life Underwriters, NAIFA comprises more than 600 state and local associations representing the interests of approximately 200,000 agents and their associates nationwide. NAIFA members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. The Association's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members.

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