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Taxation of Single Premium Life Insurance

Statement of
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Committee on Ways and Means
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TAXATION OF SINGLE PREMIUM
LIFE INSURANCE

SUMMARY OF STATEMENT BY
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Single premium life insurance policies allow one large premium to be paid up-front and combine death benefits with earnings which accumulate tax-free. Policyholders can also obtain loans from the policies at little or no cost because the income on funds invested is used to offset the interest charged to borrow. Thus, the policies provide a device for capturing investment income without reflecting it on an income tax return.

The attractive features of single premium life, combined with the loss of tax benefits on other investment products, have caused dramatic growth in single premium sales. Between 1984 and 1987 single premium life sales grew 850 percent, from $1.0 billion to $9.5 billion. During the same period, premium sales on new periodic-pay policies grew 20 percent, from $8.3 billion to $10.0 billion.

GAO believes that single premium policies may be inconsistent with congressional efforts to limit the favorable tax treatment once afforded investment-oriented life insurance products. Accordingly, GAO recommends that Congress consider legislative remedies that would eliminate the tax advantage associated with investment-oriented single premium life insurance products.

Should Congress decide to change the tax status of single premium life insurance, GAO presents two alternatives. One would tax loans from single premium policies as income in the year withdrawn. The other would remove favorable tax treatment from policies if loans reduced death benefits below certain levels.

Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to assist the Subcommittee in its deliberations on investment-oriented life insurance products. We will address our remarks today to the sales, features and tax treatment of single premium life insurance and discuss some potential approaches for changing the tax-favored status of single premium life products. In October 1987, we issued a report titled Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR, October 1987).

Single premium life insurance is a term used to describe a variety of life insurance products that give policyholders certain tax and investment benefits. The policies, which allow a relatively large single premium to be paid up front, combine death benefits with earnings which accumulate tax-free. Policyholders can also obtain loans against the policies at little or no cost because the income on funds invested is used to offset the interest charged to borrow. Thus, the policies provide a device for capturing investment income without reflecting it on an income tax return.

The attractive tax and investment features of single premium life insurance, combined with the loss of tax benefits on other financial vehicles, have resulted in dramatic growth in the sales of single premium products. Between 1984 and 1987, single premium life sales grew 850 percent, from $1.0 billion to $9.5

billion. During the same time, sales of ordinary premium life insurance grew 20 percent, from $8.3 billion to $10.0 billion.

Before I further discuss our proposed approaches for eliminating the tax advantages of single premium life insurance, I would like to provide some background on the tax treatment, sales and buyers of the products.

TAX LAWS AFFECTING LIFE INSURANCE

As part of the Deficit Reduction Act of 1984, Congress enacted statutory language that defined life insurance for tax purposes. The definition was adopted in response to concern over the proliferation of investment-oriented life insurance, which was designed to pay high investment yields, tax-free, to policyholders. The language amended the Internal Revenue Code to eliminate the tax benefits of life insurance products that (1) offered large initial investments or high investment returns and (2) maximized the advantages of tax deferral inherent to life insurance.

Section 7702 of the Code defines as life insurance any policy that meets either of two conditions or tests--the cash value accumulation test, or the guideline premium and cash value corridor test. Under the cash value accumulation test, a policy's cash value may never be more than the net single premium needed to pay all future death benefits. Under the guideline premium and cash value corridor test, the premium cannot exceed the amount needed to fund the death benefit; and the death benefit cannot be less than a set proportion of the policy's cash value depending on the age of the insured.

As long as a life insurance policy qualifies under either of the two tests, the policyholder is afforded certain tax benefits. First and foremost, the inside build-up or undistributed income on the policyholder's cash value is not subject to taxation. Second, death benefits are excluded from income so that neither the policyholder nor the beneficiary is taxed on the proceeds of the policy if paid to the beneficiary upon the death of the insured. Third, policyholders are allowed to take earnings from the policy in the form of loans without being taxed. Policy loans are taxed only when the policyholder has outstanding loans and surrenders part or all of the policy. When this occurs, outstanding loans and any other distributions resulting from the surrender are treated as income, but only to the extent that the amounts borrowed or distributed exceed the amount paid into the contract.

Like other life insurance products, single premium life is designed to qualify as life insurance under the law. In this way, policyholders enjoy all the tax benefits afforded life insurance policies including tax-free accumulation of income, tax-exempt death benefits, and tax-free policy loans. However, unlike more traditional products, single premium policies require one large premium to be paid up front. This premium--usually $5,000 or more--provides life insurance and a proportionately large investment fund. Thus, more funds are immediately available to generate income; inside build-up occurs more rapidly; and the policyholder is more quickly able to access large sums of money through policy loans.

CHARACTERISTICS OF SINGLE PREMIUM LIFE INSURANCE

Over the last few years, numerous companies have begun selling different varieties of single premium life policies. One of the more common of these products is single premium whole life, which offers the policyholder a market-sensitive interest rate on cash values for a guaranteed fixed duration--usually 1 to 5 years. Once the guarantee period ends, the insurer declares a new interest rate for an additional fixed period. Another single premium product, single premium variable life, does not guarantee current interest rates for a specific period. Instead, cash value appreciation is tied to the performance of selected investment funds.

Regardless of the type of single premium life insurance, two key characteristics stand out. The policies offer (1) market-sensitive, competitive interest rates on cash values and (2) low cost or even no-cost loans against the interest accrued. In reviewing these characteristics, we looked at separate studies compiled by A.M. Best and the Life Insurance Marketing and Research Association (LIMRA). We computed that the rate declared on 24 fixed rate policies reported by Best in September 1986 averaged 8.05 percent. Similarly, LIMRA reported that, as of December 1986, the interest rate on fixed rate policies offered by 32 companies averaged 7.7 percent. When we compared these rates to the average rate of return on tax-exempt and taxable bonds for all of 1986 (7.31 and 9.71 percent respectively), we found that, as an investment, fixed rate single premium life insurance was competitive with some of the more popular investment products.

In regard to policy loans, Best and LIMRA both highlighted the fact that the majority of the products offer low or no-cost loans. For example, in a 1987 study, Best reported that 30 of 42 companies with fixed rate single premium products offered zero net-cost loans whereby the interest rate credited to the policy on borrowed funds equaled the rate charged to borrow. The remainder offered loans at rates generally 1 to 2 percentage points higher than the interest credited to the borrowed funds. Likewise, LIMRA reported that 10 of 13 companies that sold fixed rate products during 1985 offered zero net-cost loans.

LIMRA also reported that 5 of the companies allowed immediate policy loans; and 8 allowed loans after the first policy year.

SALES AND BUYERS OF SINGLE PREMIUM LIFE INSURANCE

Over the last four years, single premium life policies have become popular. By the end of 1987, insurance companies collected almost as much revenue from single premium sales as from first-year sales of periodic pay ordinary life insurance. Between 1984 and 1987, single premium sales grew 850 percent from $1.0 billion to $9.5 billion. During the same time, the premiums on sales of periodic-pay life insurance products grew 20 percent from $8.3 billion to $10.0 billion.

Life insurance industry researchers attribute much of the dramatic growth in single premium life sales to attractive investment, tax and life insurance features. But they also cite recent legislation that resulted in the loss of traditional tax shelters. LIMRA points to the Tax Equity and Fiscal Responsibility Act of 1982 which eliminated favorable tax-treatment of withdrawals from single premium annuities. Best cites "severe limitations imposed on traditional tax shelters and the limiting of itemized deductions" by the Tax Reform Act of 1986, and indicates that the features of single premium life "make for an attractive alternative to certificates of deposit and money market holdings." Indeed, single premium life appears to be popular on the investment market. LIMRA reports that 52 percent of single premium sales during 1986 was attributable to stockbrokers. The remainder was sold by career agents that worked for one particular insurance company, or insurance brokers that sold for one or more companies.

From a buyer standpoint, single premium life policies appear to be geared toward individuals at higher income levels. A LIMRA buyer study for 1985 showed that, for adult buyers of 237 single premium policies, the average premium was $31,000 for an $82,000 death benefit. In contrast, the average buyer of periodic-pay ordinary life paid an annual premium of $548 for a $58,840 death benefit. LIMRA also profiled the typical buyer as a professional or executive over the age of 50, with 57 percent of the buyers 50 or over. In terms of income, 18 percent of LIMRA's buyers had annual employment income of $75,000 or more, 26 percent earned between $25,000 and $75,000, 25 percent made less than $25,000 and 31 percent had no employment income.

CONCLUSIONS AND RECOMMENDATION

The features of single premium life insurance seem inconsistent with congressional efforts to constrain tax advantages for investment-oriented life insurance products. First, single premium life policies require large initial premiums, thus favoring individuals with sufficient wealth to be able to afford these sums. Income on the premiums is then not subject to taxation. Second, by offering low- or no-cost loans, the policies provide policyholders the opportunity to capture investment income without reflecting it on a tax return. Loans also erode death benefits and, if not repaid before the death of the insured, defeat the primary purpose of life insurance. Finally, distributions from single premium life insurance policies tend to be similar to distributions from deferred annuities, which are taxed. Accordingly, we recommend that Congress consider legislative remedies that would eliminate the tax advantage associated with investment-oriented single premium life insurance products.

Should congress decide to change the tax status of single premium life insurance, we present two alternatives. One alternative would treat loans from single premium life insurance policies in the same manner as distributions from annuity contracts. Thus, loans from a policy would be considered as drawn from income first, and would be taxable income in the year withdrawn. The other alternative would change the definition of life insurance such that single premium contracts no longer qualify for favorable tax treatment if policy loans reduce the death benefit below certain levels already defined by law.

Although the first alternative is relatively clear-cut, the second may require further explanation. The corridor test under Section 7702 of the Internal Revenue Code disqualifies for tax-favored status any contract that allows excessive accumulation or build-up of cash value relative to the amount of life insurance provided. In effect, the death benefit must exceed the cash value by a specific percentage that decreases as the age of the insured increases.

Attachment I illustrates an actual fixed rate single premium life policy offered to a 55-year-old male. The premium on this policy is $50,000 for a $121,978 initial death benefit, and the declared interest rate at the time of purchase is 8.75 percent. Loans are provided after the first policy year at a cost of 8 percent and the policyholder is credited the same 8 percent on borrowed funds. The illustration assumes that interest rates will remain the same over the life of the policy and that, beginning with the second policy year, the policyholder borrows all the interest earned, or $4,375, at the beginning of each new year.

Attachment II illustrates the effect on the policy's death benefits if the policyholder borrows the full amount earned in the preceding year. As the table shows, the death benefit is depleted as the loan amount accumulates. However, for purposes of applying the corridor test under section 7702 of the Code, loans are not considered. Thus, even though the policy appears to have an increasing death benefit, the beneficiary would not realize the full amount if loans were outstanding.

Attachment III illustrates the effect of borrowing if the definition were changed to consider loans when computing death benefits under the corridor test. Basically, the table shows that the policyholder could take loans during the early policy years but would have to repay them shortly thereafter in order to maintain the policy's tax-favored status. If the loans were not paid back, the policy would no longer qualify as life insurance for tax purposes and the product would become a taxable investment account.

This concludes my prepared statement. We would be pleased to respond to any questions.

Attachment I

Single Premium Life Policy Illustration

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978
Current Accumulation Rate - 8.75%

Year	Accumulated Account Value	New loan at Beg. of Year	Cum. Loan at End of Year[a]	Death Benefit
1	$54,375	$0	$0	$121,978
2	59,100	4,375	$4,725	121,978
5	75,666	4,375	21,291	121,978
10	113,379	4,375	59,004	138,322
15	168,791	4,375	114,416	195,797
20	250,209	4,375	195,834	267,724

[a]Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration.

 Attachment II

Sample Single Premium Life Policy With Borrowing

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978
Current Accumulation Rate - 8.75%

			Ratio of Death Ben. to Accum. Acct. Val.		
Year	Death Benefit	Death Ben. After Loan	Actual	Minus Loan	Stat. Min.
1	$121,978	$121,978	224%	224%	150%
2	121,978	117,253	206	198	146
5	121,978	100,687	161	133	134
10	138,322	79,318	122	70	122
15	195,797	81,381	116	48	116
20	267,724	71,890	107	29	107

[a]Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.

Attachment III

Effect of Borrowing if Definitional Changes Were Adopted

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978

Year	New loan at beginning of year	Cumulative loan at end of year[a]	Death benefit after loan	Ratio of death benefit after loan to accumulated account value	Statutory minimum percent
1	$ 0	$ 0	$121,978	224%	150
2	4,375	4,725	117,253	198%	146
5	3,715	20,578	101,400	134%	134
6	(6,565)	15,134	106,844	130%	130
7	(8,059)	7,641	114,337	128%	128
8	(7,641)	0	121,978	126%	126
9	0	0	130,995	124%	124
20	0	0	284,405	107%	107

[a]Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.