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TAX POLICY

Tax Treatment of Life Insurance and Annuity Accrued Interest

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The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

This report is in response to Section 5014 of the Technical and Miscellaneous Revenue Act of 1988. Section 5014 calls for GAO to report on (1) the effectiveness of the revised tax treatment of life insurance products in preventing the sale of life insurance primarily for investment purposes; and (2) the policy justification for, and the practical implications of, the present treatment of earnings on the cash surrender value of life insurance and annuity contracts in light of the Tax Reform Act of 1986. There is a recommendation to the Congress in chapter 4.

As arranged with you, unless you publicly announce the contents of this report earlier, we plan no further distribution until 2 days from the date of the report.

Major contributors to this report are listed in appendix II. If you have any questions, please call me on 275-6407.

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Executive Summary

Purpose

The interest that is earned on life insurance policies and deferred annuity contracts, commonly referred to as "inside buildup," is not taxed as long as it accumulates within the contract. By choosing not to tax the interest as it is earned, the federal government forgoes an estimated $5 billion in tax revenue each year.

In the Technical and Miscellaneous Revenue Act of 1988, Congress asked GAO to examine the policy justification for, and practical implications of, this tax treatment. Congress also asked GAO to study how effectively the revised definition of life insurance contained in the new law restricted the sale of investment-oriented life insurance products.

Background

Inside buildup is not a form of income unique to life insurance or annuity products. It is another name for unrealized or accrued income—income earned but not yet received by an investor. Other examples of investments with accrued earnings are certificates of deposit, individual retirement accounts, 401(k) plans, original issue discount bonds, stocks, bonds, and real estate.

In general, inside buildup earned on life insurance and deferred life annuities is not taxed as long as it remains inside the policy. Since the buildup grows faster than it would if it were taxed, buyers pay lower prices for these products.

Interest that remains inside a life insurance policy accumulates as long as the policy is in force. The amount accumulated benefits the policyholder because it helps pay the increasing cost of insurance coverage as the policyholder ages and it becomes an increasing part of the policy's death benefit. The inside buildup is not subject to income tax if it is received as death benefits by the policy's beneficiary. Inside buildup is taxed if the policyholder surrenders the policy, but not if the policyholder merely borrows the inside buildup.

Inside buildup accumulates in life annuities only between the time the annuity is purchased and the time payments from the annuity begin. Unlike life insurance, funds borrowed from an annuity are taxed and a penalty tax is imposed. Once payments from the annuity begin, the previously untaxed inside buildup is paid out over the term of the annuity as part of the payment. The inside buildup received with each payment is then subject to taxation.

Results in Brief

After examining the major arguments for the current tax preference, GAO found only one to have potential merit—without this preference, people may not provide their dependents with adequate insurance protection or themselves with sufficient retirement income. However, GAO believes that inside buildup is accrued income that could be taxed. Accordingly, Congress may want to reconsider whether the social benefits of not taxing the inside buildup are worth the tax revenue forgone.

If Congress decides not to tax inside buildup, GAO believes that amounts borrowed from life insurance inside buildup should be taxed. Since borrowing the inside buildup reduces death benefits by the amount borrowed, such borrowing is not consistent with the goal of the tax preference, which is to foster insurance protection. In addition, an unlimited right to borrow the inside buildup allows policyholders access to tax-free income and is inconsistent with the tax treatment of borrowing from other tax-preferred products, such as annuities. Repayment of previously taxed amounts borrowed should be tax deductible, because repayment restores the death benefit.

Congress has narrowed the tax definition of life insurance, but that definition is likely to remain an issue as long as preferential tax treatment is granted to life insurance products. The 1988 restrictions appear to have reduced substantially the sale of a particular type of investment-oriented product—that involving a single premium paid upfront. Whether these restrictions have affected the sale of other investment-oriented life insurance products is more difficult to evaluate.

GAO Analysis

The Inside Buildup Debate

Opponents of taxing inside buildup argue that it is not income and should not be taxed because it does not usually generate cash to the owner unless the product is surrendered or liquidated. Instances exist, however, under present law where income is taxed without cash payment. For example, the annualized return on original issue discount bonds is taxed as it accrues even though no cash may be received until some time in the future. (See pp. 38 and 39.)

Alternatively, there are instances under current law where income is not taxed until cash is realized. For example, accrued capital gains are not taxed, even though they could be considered income. There are two

basic arguments for taxing capital gains only when the underlying assets are sold. First, it would be difficult to value many assets that have accrued capital gains, especially if they have not been sold in years. Second, asset prices can fluctuate substantially from year to year. Thus, taxing accrued capital gains could result in the forced sale of an asset to pay the tax.

GAO believes that the payment of cash is not a necessary condition for income to exist and to be taxed. GAO also believes that the arguments for not taxing accrued capital gains do not apply to inside buildup on life insurance or annuity products. Inside buildup is an amount that can be readily computed, and the tax on it will not likely be large enough to force even a partial surrender of the policy. Thus, the arguments for not taxing inside buildup must be based on other factors. (See p. 39.)

GAO found one argument for not taxing inside buildup to have merit. The argument is that taxing it may reduce the amount of insurance coverage purchased and the amount of income available to retirees and beneficiaries. The tax preference on inside buildup is less costly, it is argued, than direct government provision of protection.

Adequate coverage for low-income people is largely provided through the Social Security System, which provides both insurance and annuity protection. The tax preference given life insurance and deferred life annuities mainly benefits middle- and high-income people. Empirical studies on the adequacy of life insurance protection are not conclusive. Even if, under the existing tax treatment, the level of protection is adequate, GAO has no way to determine if it would remain so if inside buildup were taxed. (See pp. 41 to 43.)

Inside buildup has never been treated as taxable income. However, the tax preference has created incentives to construct products that take advantage of the preference. Accordingly, Congress may want to periodically reconsider the policy decision to forgo taxing inside buildup. The central issue, as always, is whether the benefit of the increased protection to the insured's beneficiaries is worth the tax revenues forgone. (See pp. 44 to 46.)

Policy Loans Defeat Purpose of Life Insurance

The purpose of life insurance is to replace income lost as a result of the death of the insured. Borrowing the accumulated inside buildup of a policy, however, reduces the value of death benefits and, therefore, defeats the purpose of having life insurance. (See pp. 43 to 44.)

In 1982, Congress decided to treat borrowing from annuities as taxable and imposed an additional penalty to offset the advantage of accruing interest tax free and only paying tax when funds are withdrawn. In 1988, Congress limited borrowing on certain life insurance policies by narrowing the tax definition of life insurance. One intent underlying both of these tax law changes was to reduce investor incentives to use borrowing as a source of tax-free income. (See p. 43.)

In keeping with that intent as well as to make the tax treatment of borrowing against life insurance more consistent with that of other investment products, borrowing from life insurance should be considered a realization of income and should be taxed. To offset the advantage of accruing tax-free interest income before its withdrawal, a penalty—similar to that imposed on borrowing from annuities—should be added to the tax. Since repayment of borrowed amounts restores the death benefit, any amount that was included in taxable income when borrowed should be deductible when repaid. (See p. 46.)

The staff of the Joint Committee on Taxation has estimated that a tax on borrowing the inside buildup from life insurance policies would raise, on average, over $200 million per year. (See p. 36.)

Recent Changes in Law Have Affected Product Sales

Because of concern about the growth of single premium life insurance policies, Congress narrowed the tax definition of life insurance in The Technical and Miscellaneous Revenue Act of 1988. Single premium policies, which involve a large initial payment, allow significant and rapid accumulation of inside buildup. The effect of the tax law change has been to reduce the number of single premium policies sold. The effect of this change in the law on other investment-oriented life insurance policies is more difficult to evaluate. (See pp. 32-33.)

Purchases of deferred annuities fell after borrowing from these products was taxed. Growth has since resumed and, in fact, increased after the Tax Reform Act of 1986 put limits on competitive tax-preferred products, such as Individual Retirement Accounts. (See pp. 36-37.)

Recommendation

The type of products offered as well as who buys those products can change. As a result, Congress may want to reconsider periodically its policy decision to grant preferential tax treatment to inside buildup, weighing the social benefits against the revenue forgone.

If Congress decides not to tax inside buildup, then GAO recommends that Congress eliminate tax-free borrowing of life insurance proceeds. Any borrowing of these proceeds should be considered a distribution of interest income. To offset the advantages of accruing interest income without tax, a penalty provision needs to be added. Since repayment of the amount borrowed restores the death benefit, any amount that is taxed when it is borrowed should be tax deductible if subsequently repaid.

Comments

GAO obtained oral comments from industry representatives on this report. According to them, the current tax treatment of inside buildup is justified. They believe that recent changes in the tax laws have eliminated serious abuses. In their view, loans are a legitimate part of the life insurance product and are generally used to serve important social goals, such as financing a home or paying tuition.

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Abbreviations

ACLI	American Council of Life Insurance
CDs	Certificates of Deposit
FIFO	first in, first out
IRAs	Individual Retirement Accounts
IRS	Internal Revenue Service
LIFO	last in, first out
LIMRA	Life Insurance and Marketing Research Association

Introduction

Certain life insurance and annuity products have historically been granted preferential treatment under the Internal Revenue Code. During the 1980s, many of these same products and the methods of marketing them changed significantly. Concerned about the potential for misuse of the preferential tax treatment, Congress has placed limits on these products by narrowing the definition of life insurance and by penalizing borrowing against annuities.

Whole life insurance policies are usually paid for with annual premiums spread over the life of the insured or over a specified number of years. In the early years of the policy, the premiums more than cover the cost of insurance. The excess is invested to provide for later years when the cost of insurance rises. Deferred life annuities pay benefits after a specified time has elapsed. They may be paid for with either a single premium or with a series of premiums that stop before or at the end of the period of deferral.

Both whole life insurance and deferred annuities offer forms of protection to the purchaser, but they are also used for savings. The basic tax advantage common to both is that the interest earned on the savings element is not taxed as it accumulates. For life insurance, the savings element plus interest earned is used in later years to supplement premium payments when mortality costs are higher and to pay a part of the promised death benefits. If the insured dies, the interest accumulation is paid to the beneficiary and is not subject to income tax. If the insured surrenders the policy, the interest accumulation will be subject to tax as long as the cash value plus the sum of dividends previously paid out to the policyholder is greater than the sum of premiums paid by the policyholder. No tax is levied on borrowing the inside buildup. For annuities, the savings plus interest earned pay a part of the annuity benefits. No tax is levied on accumulated interest until the annuity benefits are actually paid out. However, any amount borrowed or withdrawn during the period of deferral is taxable. Because the interest is not taxed as it is earned, both the surrender of life insurance policies and the cashing in of deferred annuities involve postponement of tax.

The exclusion from taxation of most interest income earned on life insurance and annuity contracts is estimated to cost the federal government over $5 billion a year, according to the Joint Committee on Taxation. If just the interest income on new life insurance policies were taxed, revenue would reach about $900 million a year in 5 years, according to the Congressional Budget Office.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress decided to treat borrowing from deferred annuities as a taxable distribution. Except for a limited set of circumstances, an additional penalty tax was imposed on the amount borrowed to offset the benefits policyholders gained from tax deferral. Concerned about an increasing number of investment-oriented life insurance products, Congress, for the first time, explicitly defined a life insurance policy for tax purposes in the Deficit Reduction Act of 1984. With a rapid increase in the sale of single premium life insurance products, Congress further narrowed the tax definition of life insurance in the Technical and Miscellaneous Revenue Act of 1988. To be considered life insurance for tax purposes, a policy must involve at least seven annual premiums. A policy with fewer than seven annual premiums is called a "modified endowment policy" and has very restrictive borrowing privileges, much like those of annuities.

Objectives, Scope, and Methodology

The Technical and Miscellaneous Revenue Act of 1988 directed that we examine the policy justification for the current tax treatment of inside buildup in life insurance and annuity products, as well as analyze the practical implications of that treatment. In addition, we were to study how effectively the law's revised definition of life insurance prevented the sale of life insurance products primarily for investment purposes.

To examine the justification for, and policy implications of, the current tax treatment, we examined accounting, actuarial, economic, and insurance journals and periodicals. In addition, we studied statements and testimony of industry representatives and economic, legal, and insurance experts. From our literature search, we extracted what we believe to be the primary arguments for and against the current tax treatment of inside buildup. Chapter 4 discusses these arguments and evaluates their strengths and weaknesses.

We examined trends in the industry to determine the policy implications of the tax treatment of inside buildup and the effects of the new definition of life insurance. Our primary sources of data used to examine these trends were the 1988 Life Insurance Fact Book and the 1989 Life Insurance Fact Book Update, both of which were published by the American Council of Life Insurance; and various reports and pamphlets published by the Life Insurance and Marketing Research Association, Inc. (LIMRA). To gain a fuller understanding of the products that are available and their relative importance, as well as to discuss the most recent trends in the industry, we visited the offices of LIMRA and interviewed LIMRA officials.

We received informal oral comments from representatives of the life insurance industry. Since they believe the current tax treatment is proper, they disagreed with our position. Our work was done between April and September 1989, primarily in Washington D.C. and in accordance with generally accepted government auditing standards.

What Is Inside Buildup?

The interest that accumulated on life insurance policies and deferred annuities was an estimated $45 billion in 1986. Each year policyholders and future annuitants accumulate an amount of this magnitude on a tax-free or tax-deferred basis. In deciding whether inside buildup is to remain tax-preferred or to be considered a source of tax revenue, it is necessary to understand what it is and the purpose it serves.

"Inside buildup" refers to the growth of interest income within life insurance policies and deferred annuities. Inside buildup is not a unique form of income: it is simply another name for unrealized income or gains—income that has been earned but not received by an investor.

Unrealized income or gains occur with many kinds of investments. These investments include certificates of deposit (CDs); individual retirement arrangements (IRAs); 401(k) plans; original issue discount bonds, such as zero coupon bonds; stocks and bonds (capital gains); and real estate. For instance, CDs earn interest income as they are maturing, but investors have the option of not receiving the income until the CD has matured. Stocks and bonds, even though they pay a periodic income as dividends or coupon interest, may appreciate in value. This appreciation or capital gain is earned by investors but is not received until the stock or bond is sold.

Life Insurance and Inside Buildup

Life insurance enables individuals to reduce the risk of financial loss to their families or other parties in the event of the policyholder's death. Risks are reduced by pooling the risks (i.e., the probability of death) of many individuals. If the risks are small, the cost to each individual will also be small. For example, if 10,000 people wished to provide $10,000 to their families if they died in the next year, and the insurance company estimated that only 10 of the 10,000 people would die during the year, the cost of the insurance would be $10 per person ($100,000 benefits paid / 10,000 policyholders = $10 per policyholder). However, if the insurance company estimated that 5,000 people would die, the cost would jump to $5,000 per person.[1]

This example illustrates the fundamental nature of life insurance: as the probability of death increases the cost of insurance also increases. While the nature of insurance remains the same, the industry has developed a multitude of insurance products, such as universal life and variable life

[1]This example disregards what are called "loading charges." These costs are included in life insurance premiums so that insurance companies can cover their costs of doing business.

insurance, to meet the varied needs of people. However, all the policies offered are essentially variations on the two basic types of insurance: term (temporary) insurance and whole life (permanent) insurance.

Term Insurance

Term insurance pays the beneficiary of a policy the promised death benefits if the insured dies within a certain period of time (usually 1 year). A 1-year term policy involves almost no savings; it is often termed "pure" insurance.

The premium for a given amount of term insurance increases with the age of the insured because the insured's probability of death increases. With a greater number of people dying each year as a given group of people grows older, insurance companies must charge higher and higher premiums to cover the promised death benefits. Thus, a given amount of term insurance that costs people hundreds of dollars a year when they are in their 20s may cost them thousands of dollars a year when they are in their 60s. For example, a $100,000 1-year term policy that costs a person $169 at age 25 would cost $2,421 by age 65. If a person age 25 lived to age 99 and purchased a $100,000 1-year term policy each year, total premiums paid over the years would equal $636,187.[2]

The increasing cost of term insurance is a major drawback in holding this type of insurance. As people age, their incomes may not increase as fast as the insurance premiums. The premiums may take a larger and larger portion of their income over time. This problem is solved with whole life (permanent) insurance.

Whole Life Insurance

Under a whole life insurance policy, coverage of $100,000 a year from age 25 to 99 could be purchased for 75 annual premiums of $676, or a total of $50,700. Whole life insurance pays the beneficiary of a policy the promised death benefits (face value of the policy) whenever the insured dies. It does this through a combination of decreasing term insurance and increasing accumulated savings. The sum of these always equals the face value of the policy.

[2]The premiums, which do not include loading costs, are calculated using the 1980 Commissioners' Standard Ordinary Mortality Table for males, with an interest rate of 5 percent. This example, and others throughout the report, are not intended to represent actual policies sold by the insurance industry. They are used only to describe the relationship between premiums, cash values, and death benefits for various kinds of policies.

The premiums for whole life may be spread over the life of the insured. However, unlike term insurance, whole life premiums do not increase with the age of the insured. The "excess" premiums are invested by insurance companies and earn interest income for policyholders. For whole life premiums to pay the increasing cost of mortality (the increasing costs of term insurance as the insured ages), they must be greater than the premiums for term insurance in the early years of the policy.

The difference between the whole life premiums and the cost of the actual term insurance provided in the early years of a policy represents the savings element of life insurance. The "excess" premiums are invested by insurance companies and earn interest income for policyholders. The accumulation of interest income in an insurance policy is the inside buildup.

The sum of the accumulated excess premiums and interest income equals the cash value of a policy. The cash value of a whole life policy is available to policyholders during their lives through surrender of the policy or through borrowing. As the cash value of a policy grows, the amount of actual insurance coverage that needs to be provided to maintain the face value or death benefits of a policy decreases. However, the cash value plus the actual insurance coverage always equals the face value of a policy.

As the insured ages, the cost of insurance coverage begins to exceed the annual premiums. At this time, the accumulated excess premiums and inside buildup (accumulated interest income) are used to supplement the annual premiums. In effect, interest income earned for policyholders by the insurance company is used so that policyholders may pay the increasing cost of their insurance coverage and, as will be shown, is used to supplement the decreasing level of actual insurance protection provided by the company.

The savings aspect of whole life insurance may be increased by paying larger and fewer premiums early in the policy. If premiums are paid early, inside buildup accumulates in greater amounts. For instance, it was common to pay premiums for whole life insurance over 20 years instead of over the life of the insured. At the end of 20 years, the inside buildup and accumulated excess premiums were sufficient to pay the costs of insurance coverage for the rest of the insured's life. The savings element of whole life is taken to the extreme when it is paid for with a single premium; such a policy provides the greatest accumulation of

interest income. Another type of policy, universal life, allows policyholders to vary, within certain limits, the amount of death benefits and the timing and amount of premiums. This policy allows them to determine how much of their premiums is saved and how the interest income is used.

One incentive to purchase whole life rather than term insurance is that, unlike comparable investments, interest income built up within the policy is not taxed as it is earned. This incentive will vary depending on how interest rates paid on the savings aspect of life insurance compare with the rates offered on other taxable investments.

Inside Buildup Illustrated

Table 2.1 shows the annual premiums for 1-year term, annual premium, and single premium life insurance for a $100,000 policy purchased beginning at age 25. For about the first 25 years, the premiums on 1-year term insurance are lower than those on annual premium whole life. The difference between the two policies is approximately equal to the excess premiums that are saved and invested for the whole life policyholder.[3] For the single premium policy, virtually the entire premium is saved and invested. The premium plus inside buildup on a single premium policy is enough to pay the cost of actual insurance coverage over the life of the insured.

Table 2.1: Annual Premiums on $100,000 Life Insurance Policies

	Type of Policy		
Age	1-Year term	Annual premium	Single premium
25	$169	$676	$12,432
35	201	676	•
45	433	676	•
55	997	676	•
65	2,421	676	•
75	6,113	676	•

Note: Premiums were computed using the 1980 Commissioners' Standard Ordinary Mortality Table for males and an interest rate of 5 percent. The premiums do not include loading costs.

[3]The difference is only approximate because under the 1-year term policy the insurance coverage stays at $100,000 while under the whole life policy the insurance coverage, not the face value of the policy, decreases as the policyholder ages and the cash value builds up. The cost of insurance coverage under a whole life policy is therefore less than under the 1-year term policy.

As the cash value (excess premiums and interest income) builds up within a whole life policy, the amount of actual insurance coverage provided decreases. If a person reaches the maximum age in a mortality table, the actual insurance coverage for the last year is zero. The death benefits are then totally provided for out of the inside buildup. Tables 2.2 and 2.3, based on the premiums used in table 2.1, show the relationships between the excess premiums, inside buildup, cash value, and actual insurance coverage for the whole life and single premium policies.[4] For 1-year term insurance there are no excess premiums, inside buildup, or cash value.

Table 2.2: Excess Premiums, Inside Buildup, Cash Value, and Actual Insurance Coverage for a $100,000 Annual Premium Whole Life Policy

Age	Cumulative excess premiums	Inside buildup	Cash value	Actual insurance coverage	Face value
25	$508	$26	$534	$99,466	$100,000
35	5,609	2,010	7,619	92,381	100,000
45	9,699	8,207	17,905	82,095	100,000
55	11,326	20,165	31,906	68,509	100,000
65	8,335	39,321	47,656	52,344	100,000
75	(2,169)	66,410	64,241	35,759	100,000
85	(22,936)	100,693	77,757	22,243	100,000
95	(51,258)	140,540	89,283	10,717	100,000
99	(58,557)	158,557	100,000	0	100,000

Table 2.3: Excess Premiums, Inside Buildup, Cash Value, and Actual Insurance Coverage for a $100,000 Single Premium Whole Life Policy

Age	Cumulative excess premiums	Inside buildup	Cash value	Actual insurance coverage	Face value
25	$12,285	$614	$12,899	$87,101	$100,000
35	10,832	8,271	19,103	80,897	100,000
45	8,493	19,618	28,111	71,889	100,000
55	3,998	36,010	40,008	59,992	100,000
65	(4,541)	58,704	54,163	45,837	100,000
75	(19,659)	88,346	68,687	31,313	100,000
85	(43,764)	124,287	80,523	19,477	100,000
95	(74,484)	165,099	90,615	9,385	100,000
99	(83,244)	183,244	100,000	0	100,000

The cash value (excess premiums plus inside buildup) plus actual insurance coverage equals the face value of the policy, $100,000. The excess

[4]The calculation of excess premiums is presented in appendix I.

premiums in the early years are positive when they are saved and earn interest income. By ages 65 and 75 in these examples, the excess premiums become negative; at this time, the inside buildup begins to supplement the annual premium to pay the cost of the actual insurance coverage. For the single premium policy, the inside buildup pays the entire cost of the actual insurance coverage. The remainder of the inside buildup supplements the actual insurance coverage so that the value of the death benefits remains constant. By age 99, the highest age used in the mortality table, the inside buildup has grown to equal the death benefits; the actual insurance coverage at this age is zero.

As can be seen from tables 2.2 and 2.3, the inside buildup on the single premium policy for each year is greater than that for the annual premium policy, because the excess premiums invested in the policy in the beginning are much greater in the single premium policy.

In summary, inside buildup on life insurance is unrealized income to policyholders, income that is used to help pay the increasing costs of their actual insurance and to pay an increasing part of their death benefits. It is income that, when realized, may never be taxed.[5]

Life Annuities and Inside Buildup

Life annuities are, in a sense, the opposite of life insurance. While life insurance pays a benefit when the insured dies, life annuities pay benefits (usually annually or monthly) as long as the insured lives or for a specified period of time if living. Life annuities are used as a source of retirement income. For instance, people may invest their IRA savings in life annuities and begin drawing benefits when they retire.

Life annuities may be either immediate or deferred. An immediate annuity is purchased with a single premium and begins to pay benefits right away. The premium is invested and earns interest income. The interest income, along with a part of the premium, is paid out as it is earned, and thus constitutes the annuity's benefits. When the insured dies, any premium remaining helps pay the benefits of other annuitants. These amounts are called "survivorship benefits." Because the interest income under an immediate annuity is paid out as it is earned, no inside buildup accrues in such a policy.

[5]See chap. 3 for a discussion of the tax treatment of inside buildup.

Deferred life annuities pay benefits after a specified time has elapsed or a certain age is attained. They may be paid for with either a single premium or with a series of premiums that stop before or at the end of the period of deferment. Like immediate annuities, deferred annuities earn interest income; unlike immediate annuities, the interest income earned builds up within the policy during the period of deferment and is available to pay annuity benefits. As with life insurance, the sooner the premiums are paid, the greater the amount of inside buildup.

If the interest rates offered on life annuities are competitive, one reason for buying a deferred life annuity now rather than an immediate life annuity later is that the inside buildup accumulated during the period of deferment is not taxed as it is earned. The same annuity may therefore be purchased with a smaller after-tax premium, measured in present value terms. For example, a $10,000 immediate annuity may be purchased for a $116,855 premium at age 60. If the insurance company guarantees an interest rate of 6 percent, the same annuity may be purchased for a $13,403 premium at age 25. However, if people wanted to save the money themselves to pay the premium at age 60, they would have to invest $26,594 at age 25, assuming a 6-percent return in a taxable investment. Their cost would be almost 100 percent greater.[6]

Inside Buildup Illustrated

In the same manner as permanent life insurance, inside buildup is earned but not realized on deferred life annuities. Once annuity benefits begin, however, interest income stops building up within the annuity. When part of the accumulated interest income is included in the annuity benefits, the inside buildup paid out is realized as income.

The inside buildup on deferred life annuities plus the premiums paid (plus survivorship benefits) must equal the single premium on an immediate life annuity of the same amount. This equality can be seen by considering the premiums and inside buildup on representative immediate, deferred, and single premium deferred life annuities.

The premiums on a $10,000 life annuity beginning at age 60 and ending at the death of the annuitant are presented in table 2.4. The premium at age 60 is $116,855. The same annuity may be purchased at age 25 for 35 annual premiums of only $886 for a total of $21,020; it may also be purchased for a single premium of $13,403 at age 25. Since the reserves

[6]There are tax-deferred alternatives to purchasing a deferred annuity. For instance, people may save through IRAs and buy an immediate annuity when they retire.

(the amount of funds in a policyholder's account) on both deferred annuities must equal $116,885 by age 60 if they are to pay the same benefits, the differences between the premiums are made up with inside buildup (plus survivorship benefits).

Table 2.4: Premiums on a $10,000 Life Annuity Beginning at Age 60

	Type of annuity		
Age	Immediate	Annual premium deferred	Single premium deferred
25	•	$886	$13,403
30	•	886	•
35	•	886	•
40	•	886	•
45	•	886	•
50	•	886	•
55	•	886	•
60	$116,855	•	•

Note: Premiums were computed using the 1971 Male Annuity Mortality Table with an interest rate of 6 percent. The premiums do not include loading costs.

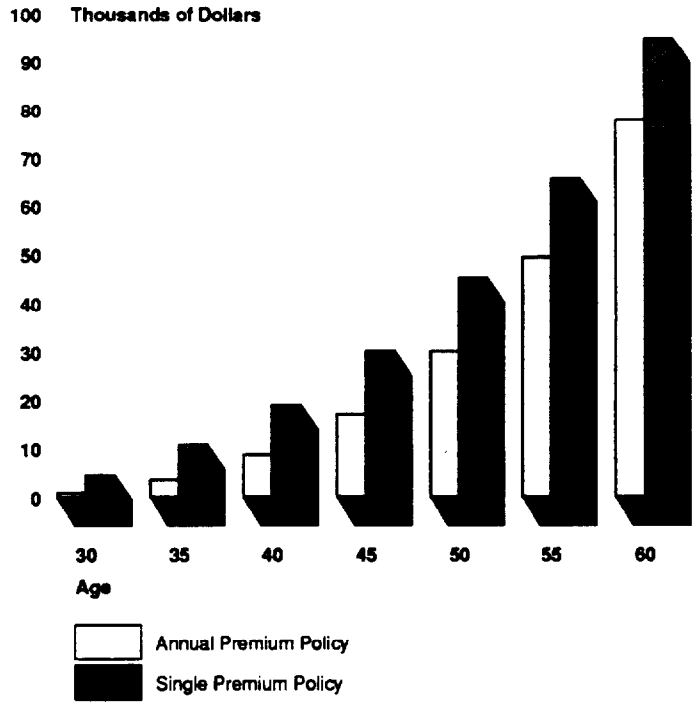
Figure 2.1 shows the cumulative inside buildup on the annual premium and single premium deferred annuities. The amount of inside buildup on the annual premium deferred annuity is about $78,000 at age 60. This interest income plus the premiums paid, $31,010 ($886 x 35), almost equals the cost of the immediate annuity.[7]

The single premium deferred annuity earns a greater inside buildup. By age 60, when the annuity begins, the inside buildup totals about $95,000. This buildup is almost 22 percent more than under the annual premium deferred annuity. In both cases, the inside buildup accumulates tax-free, to the benefit of the policyholder. Only when the annuity begins is the inside buildup taxed.[8]

[7]The difference is made up from the reserves (premiums, interest income, and survivorship benefits) of those annuitants who died during the period of deferment. Those reserves are allocated to the accounts of the living.

[8]See chap. 3 for a discussion of the tax treatment of inside buildup on deferred annuities.

Figure 2.1: Cumulative Inside Buildup Earned on a $10,000 Deferred Life Annuity



Favorable Tax Treatment of Inside Buildup Encourages Investment-Oriented Products

The inside buildup on life insurance and deferred annuities is treated similarly under current tax law as long as the funds remain in the product. However, tax law treats funds that are withdrawn or borrowed from a life insurance policy more favorably than funds withdrawn or borrowed from an annuity.

Tax treatment of investments does not always resemble that of life insurance and annuities. The tax treatment of interest accumulating in whole life insurance and deferred annuities resembles the tax treatment of interest accumulating on other forms of deferred compensation, such as individual retirement accounts. There are, however, important differences. Unlike these other deferred compensation products, there are no legal limits on how much can be invested in life insurance and annuity products. In addition, no tax consequences result from borrowing from a life insurance policy. The only borrowing limit is the cash value of the policy. The tax treatment of life insurance products closely parallels the tax treatment of capital gains income. However, it is not clear that inside buildup and accrued capital gains have as much in common as their respective tax treatments would indicate.

The tax preference granted to inside buildup increased the variety of investment-oriented life insurance products and the amounts invested in those products. Some of these products have led to concerns that the tax preference generates products that are geared more to investment purposes than to life insurance purposes. There are different ways of alleviating those concerns. Changing the definition of life insurance is one of those ways.

To restrict the ability of investors to put large amounts of money in policies that were more oriented toward generating tax-preferred investment returns (inside buildup) and less oriented toward life insurance protection, Congress defined life insurance for tax purposes in the Deficit Reduction Act of 1984. Because of the rapid increase in the sales of single premium life insurance policies in the mid-1980s, Congress narrowed the definition further in the Technical and Miscellaneous Revenue Act of 1988.[1] The sales of a specific product, the single premium policy, appear to have fallen as a result of this 1988 tax law. However, it is more difficult to evaluate how these changes in definition have affected the sale of investment-oriented life insurance policies in general.

[1]These policies allowed for a large and rapid accumulation of inside buildup. In addition, they often provided very liberal loan provisions. For a more detailed discussion, see Tax Policy: Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR), October 16,1987.

More direct approaches exist to achieve the goals of reducing the investment-orientation of life insurance and of keeping policyholders from gaining easy access to tax-preferred funds. If the concern is that investors have the ability to shelter large amounts of income from tax, a tax on inside buildup or limits on the amount of life insurance that is granted tax-preferred status might more effectively deal with that concern. If the concern is the ready access to tax-preferred funds through borrowing, then limiting or taxing borrowing may be a better approach than altering the definition of life insurance.

Life Insurance and Annuity Inside Buildup Are Taxed the Same Inside but Differently Once Outside of the Product

As funds remain inside a life insurance or deferred annuity product, they generate interest that is credited to the product's owner. If these funds remain in the policy or annuity, the interest accumulation is not taxed. Once the funds are realized (i.e., taken out of the policy or annuity), the tax treatment accorded annuities differs greatly from that of life insurance. Inside buildup on a life insurance policy may be realized by the policyholder or beneficiary through (1) death benefits, (2) policy loans, (3) surrender of the policy, or (4) policy dividends. For annuities, inside buildup can be realized through (1) liquidation—when payment of funds into the annuity stops and payment of funds out of the annuity begins—, (2) loans against the annuity, (3) cashing in the annuity—if this is allowed—, or (4) policy dividends. In the following sections, we will describe how each of these forms of realization are taxed under current law.

Unrealized Inside Buildup Not Taxed for Annuities or Life Insurance

The inside buildup and, in some types of policies, the policyholder dividends generated by funds on deposit in a life insurance policy accumulate without current taxation.[2] As a result, the inside buildup grows faster than it would if it were subject to current taxation. The faster the buildup of interest inside a policy, the lower the premiums insurance companies will charge for the same coverage. Table 3.1 shows the difference in premiums on a $100,000 whole life policy under the current tax treatment—that is, with no tax on inside buildup and with a hypothetical tax of 28 percent on the interest accumulation. Lower premiums obviously benefit both insurance companies and their policyholders.

[2]In certain situations, a current tax is generated by the accumulation of policyholder dividends in a policy. See the section on policyholder dividends.

Table 3.1: Premiums for $100,000 Whole Life Insurance Policies When Inside Buildup Is Taxed and Not Taxed

	Premiums	
Type of policy	Inside buildup not taxed	If buildup were taxed
Annual premium	$676/year	$909/year
Single premium	$12,432	$20,742

Note: Premiums based on a policy purchased by a 25-year-old male using 1980 Commissioners' Standard Ordinary Mortality Table for males with an interest rate of 5 percent and a marginal tax rate of 28 percent. Premiums do not include loading costs.

From the insurance companies' standpoint, lower premiums mean they can sell more policies or more insurance per policy. Lower premiums are possible because the inside buildup grows at a faster rate when not taxed and can eventually pay a greater portion of the promised death benefits. From the policyholders' standpoint, the amount paid for a given amount of insurance is lower and the amount invested in the policy (i.e., the unused premiums) earns interest income at a higher rate than if it were taxed. The cash value of the policy (unused premiums plus accumulated interest income) is available to policyholders through borrowing or upon surrender of the policy in whole or in part.[3]

Inside buildup on deferred annuities is given the same tax treatment accorded unrealized interest income earned on life insurance. As premiums are paid into a deferred annuity but before any amount is actually received by the annuitant, the interest income earned accumulates without any current tax. The owner's wealth increases with the interest accumulation and at a faster rate than if the interest accumulation were subject to current taxation. Table 3.2 shows the difference in premiums on a $10,000 deferred annuity with no tax and with a hypothetical tax of 28 percent on the inside buildup. From the standpoint of the annuity owner, fewer resources or out-of-pocket costs are needed to provide income for retirement, for example, or for any other purpose.

Table 3.2: Premiums for Deferred Annuity of $10,000 Annually When Inside Buildup Is Taxed and Not Taxed

	Premiums	
Type of policy	Inside buildup not taxed	If buildup were taxed
Annual premium	$886/year	$1,480/year
Single premium	$13,403	$27,064

Note: Premiums based on a deferred annuity purchased by a 25-year-old male to begin at age 60 using the 1971 Male Annuity Mortality Table and an interest rate of 6 percent. Premiums do not include loading costs.

[3]Surrendering a life insurance policy means exchanging the policy for all or part of its cash value.

Inside Buildup Not Taxed When Realized on Death of Insured but Taxed When Realized as Annuity Benefits

The basic purpose of life insurance is to provide protection against income loss to beneficiaries who are often dependents of the insured. The death of the insured terminates the whole life insurance policy. The accumulated interest income or inside buildup in a life insurance policy is not taxed when paid to the beneficiary on the death of the insured. Death benefits have been exempt from federal income tax on welfare and humanitarian grounds because they are usually paid to a family that has suffered the loss of the primary earner.[4]

Liquidation of a deferred annuity terminates the deferral period. Payment of funds into the annuity has ceased and payment of funds out of the annuity begins with liquidation. Unlike the accumulated inside buildup included in life insurance death benefits, the interest accumulated in annuities is taxed when it is paid out as annuity benefits. Consequently, the inside buildup on deferred life annuities is only tax-deferred, not tax-free as in the case of death benefits from life insurance.

The tax law contains a formula that separates the part of an annuity payment that is interest, and therefore taxable, from the part that is a return of principal and not taxable. The IRS formula is easier to use than actuarial tables, but the result obtained from the formula is only an approximation. It slightly understates taxable income in the early years and overstates taxable income in the later years. As a result, in the early years, there is some additional deferral of tax on annuities. Table 3.3 compares taxable income computed under the IRS formula with taxable income computed using an actuarial table on an annuity that pays $10,000 a year. For the first 24 years, taxable income is understated by about $500 a year and then overstated by about $500 a year thereafter.

Table 3.3: Taxable Income, After Annuitization, on a $10,000 Annualized Deferred Annuity Computed Under IRS Formula and Actuarially

	First 24 years	Subsequent years
IRS formula	$8,718	$10,000
Actuarial formula	9,254	9,514

Note: Computations based on a $10,000 annualized deferred annuity beginning at age 60 and purchased at age 25 with 35 annual premiums. The 1971 Male Annuity Mortality Table was used with an interest rate of 6 percent.

[4]These death benefits may not totally escape taxation since they are included in the tax base of the federal estate tax and may be subject to state income or estate taxes. The current tax credit for the federal estate tax, however, is equivalent to about a $600,000 exemption so that the applicability of the tax is limited.

Surrendering a Life Insurance Policy or Taking a Distribution From an Annuity Is Taxable but the Treatment Is Different

The cash value received by a policyholder upon the surrender of a life insurance policy is subject to income tax to the extent that cash value plus any policy dividends previously received is greater than the sum of premiums paid. Thus, the taxation of a full or partial surrender of a life insurance policy assumes that the principal is recovered first and the interest is recovered afterwards (often termed FIFO for "first-in-first-out"). That is, any receipt of cash value is deemed to be first a return of premiums paid and only then a return of interest income earned. As a result, partial surrenders need not lead to any payment of tax until the total amount received is greater than the amount paid.

Not only is the interest income taxed after the principal has been recovered, but the amount that is considered principal for tax purposes is overstated. The calculation of taxable income uses total premiums paid as a measure of principal. However, part of the premium in each year is used to purchase insurance coverage, and the remainder accumulates as part of the policy's cash value. As a result, the current method of determining taxable income, which ignores the cost of insurance, overstates the amount of principal on which the inside buildup was earned. Since the principal amount is overstated, the amount of inside buildup taxed is less than the actual amount earned. A more correct basis for calculating the taxable interest accumulation would therefore be the sum of premiums paid less the cost of insurance coverage, since it is only excess premiums that are invested at a return and therefore properly considered principal.

On the other hand, distributions from an annuity that are over and above the regular annuity payments are taxed as if they were interest income first, at least until all of the interest accumulation has been received. Distributions from annuities are thus said to be taxed on a LIFO, or last-in-first-out basis. That is, any receipt of funds is deemed to be first a return of interest income earned—which is taxable—and only then a return of premiums paid—which is not taxable. In addition, if the annuitant has not yet reached the age of 59-1/2 or fulfilled certain other conditions, an additional penalty tax of 10 percent is assessed on the distribution.

Borrowing Against Inside Buildup Is Tax-Free for Life Insurance but Taxable With a Penalty for Annuities

If a policyholder borrows the inside buildup from his or her life insurance policy, the amount borrowed is considered a transfer of capital, not a realization of income, and, therefore, is not subject to taxation. This reasoning is in accord with tax policy on other types of loans, such as consumer loans or home mortgages. These loans are merely transfers of capital or savings from one person to another through a financial intermediary. The ability to borrow against a life insurance policy means that the interest income that is supposed to be building up to fund death benefits can instead be a source of untaxed current income. If the loans are not repaid, the inside buildup will never be taxed; death benefits will simply be reduced by the amount of the loan. Thus, policyholders have the use of tax-free income for purposes other than insurance at the expense of reduced death benefits for their beneficiaries.[5]

The 1982 Tax Equity and Fiscal Responsibility Act treats a loan from an annuity as a distribution of annuity proceeds for tax purposes. The amount borrowed is considered a distribution of interest income first and is subject to tax. The purpose of this treatment is to discourage the use of annuities for short-term investment and tax deferral purposes, while maintaining the tax benefits for long-term investment and retirement uses. Taxing amounts borrowed reduces the incentive to realize income on a current basis from what is meant to be deferred compensation or savings for retirement. If the annuitant has not yet reached the age of 59-1/2 or fulfilled certain other conditions, a penalty tax of 10 percent is also assessed on the amount distributed. Due to the time value of money, it always pays to postpone paying a tax rather than to pay it currently, unless there is some expectation of a significant increase in tax rates in the future. As a result, a penalty is imposed to offset the benefits of deferring the tax on interest income.

Taxation of Policyholder Dividends Paid on Life Insurance Differs From That of Dividends Paid on Annuities

Both life insurance and annuities can pay dividends to policyholders to the extent that investment performance is better than a stated or guaranteed rate of return or to the extent that mortality experience turns out to be better than expected. Part of the investment income on life insurance policies and annuities can be guaranteed, much like a bond or some savings accounts, while part of the investment income can depend on performance and is paid at the discretion of the company, as in certain money market or equity instruments. Investment income paid at the

[5]Similarly, homeowners may borrow against the untaxed equity appreciation in their homes and not pay an income tax on the funds received. However, the interest paid on a home equity loan is tax-deductible, while the interest paid on a life insurance policy loan is not tax-deductible.

discretion of the company is considered a dividend. If such dividends are reinvested and left to accumulate inside a whole life insurance policy, the interest earned on them is taxable. In addition, the dividends themselves are taxable to the extent that the sum of dividends accumulated over the life of the policy is greater than the sum of premiums paid by the policyholder.

Policy dividends paid on annuities, however, are usually taxable. If earned after the annuity starting date, the dividends are included in the policyholder's gross taxable income. If earned before the annuity starting date, they are taxed unless retained by the insurer as a premium or other consideration paid for the annuity.[6]

Comparison of Tax Treatment of Life Insurance and Deferred Annuities With Other Investments

There are both similarities and differences between the tax treatment of life insurance and deferred annuities and the tax treatment of certain alternative investment vehicles.

In one comparison, the tax treatment of 401(k) and deductible IRA contributions is, in effect, the same as the tax treatment of life insurance death benefits.[7] Funds deposited in 401(k) and deductible contributions made to IRA plans are tax-deductible. These funds and any accumulated interest are taxable without penalty when withdrawn from the account after age 59-1/2. Funds used to purchase life insurance are not tax-deductible, but death benefits—including the accumulated interest income or inside buildup—are not taxed. These two approaches are equivalent in present value terms if tax rates are the same when funds are received as when funds are deposited.[8]

Another comparison showing similar tax treatment is that between nondeductible contributions to IRAs and life insurance policies that are surrendered. In both cases, the interest income or inside buildup is not taxed as it is earned, but it is taxed when realized—when funds are

[6]Considerations are the amounts paid into annuities. They are the equivalent of premiums on life insurance policies.

[7]Deductible IRA contributions are those taken by individuals (single) without a qualified employer-sponsored pension fund or, up to a limit of $2,000, by those with incomes below $25,000. Nondeductible IRA contributions are those taken by everyone else. While the amount contributed to such an IRA is not deductible, the interest income is not subject to tax until the IRA is cashed in at retirement.

[8]Because the amount paid into a 401(k) or deductible IRA is not taxed, the principal invested is larger by the tax not paid. If this untaxed amount accumulates with interest until withdrawn, the tax on the amount withdrawn will have the same present value as would a tax on the original amount.

withdrawn from an IRA at retirement or when the life insurance policy is surrendered.

Another useful comparison is the similarity in tax treatment of capital gains, which represent an increase in wealth, and the tax treatment of accrued interest. Capital gains are not subject to income tax as they accumulate (or accrue) but are taxable when the underlying asset is sold and the capital gain is "realized." This treatment closely parallels the surrender of life insurance policies because the interest accumulation is not taxed as it accrues but becomes taxable upon surrender to the extent that the surrender value exceeds the sum of all premiums paid into the policy.

The treatment of capital gains at death also resembles the treatment of life insurance death benefits. Neither is included in the income of the deceased, and the basis for determining capital gains is adjusted for the beneficiary, effectively removing any tax liability for capital gains that occurred from the time of purchase through the time of death. Death benefits paid from a life insurance policy are also not taxable as income to the beneficiary.

In contrast, some investments are taxed differently. Interest that accumulates on certificates of deposit is taxable on a current basis even though the interest may not be realized by the investor until the certificate matures. Original issue discount bonds are those with low or zero coupon or explicit interest rates. These bonds, however, have a difference between the issue price and the value of the bond at maturity. A set of rules specified in the tax code imputes annual interest amounts on these bonds, rather than allowing taxes to be deferred until cash is received when the bond matures or is sold. In both these cases, interest is taxed even though no cash is received. The way that income accrues on original issue discount bonds most closely parallels the way that inside buildup accrues in life insurance and annuity products.

Table 3.4 summarizes the tax treatment of these alternative forms of savings, showing the similarities and differences in tax treatment.

Table 3.4: Taxation of Instruments With Accrued Gains

Investment	Contribution is taxed	Accrued gain is taxed	Realization of gain is taxed
Life insurance	yes	no	yes/no[a]
Deferred annuities	yes	no	yes
Nondeductible IRA contributions	yes	no	yes
Deductible IRA contributions	no, but amount limited	no	yes, principal and interest
401(k) plans	no, but amount limited	no	yes, principal and interest
Certificates of deposit	yes	yes	-
Original issue discount bonds	yes	yes	-
Capital gains	yes	no	yes/no[b]

[a]Realized accrued gain is not taxed when received as death benefits; it is taxed when received on surrender of the policy.

[b]Accrued capital gains are not taxed under the income tax when the owner dies; on the date of the owner's death, the asset's value becomes the beneficiary's new basis for subsequent taxation.

The two aspects in which the tax treatment of deferred compensation instruments differs most substantially are in "premature" distributions and borrowing. Premature distribution is the withdrawal of funds from a retirement instrument before the holder is 59-1/2 years of age, or from a life insurance policy before the death of the policyholder. Borrowing from these instruments involves withdrawing funds without forfeiting benefits if the funds are repaid.

Distributions from IRAs and 401(k) plans before age 59-1/2 involve a tax, including a 10-percent penalty, on the full amount withdrawn except in very special circumstances, such as the disability of the owner. If the owner of a deferred annuity takes a distribution during the deferral period, the amount is taxed with a 10-percent penalty as well. Early withdrawals from a life insurance policy are usually made by surrendering part or all of the policy. As discussed earlier, early withdrawals can be taxed.

Borrowing from IRAs is not allowed. Borrowing from 401(k) plans is limited to one-half of the employee's accrued benefit in the retirement plan

up to a limit of $50,000.[9] Borrowing from annuities is treated as a distribution from the annuity and is taxed with a penalty. No tax consequences result from borrowing from a life insurance policy, and the only limits are the cash value of the policy.

Implications of Tax Preferences on Life Insurance and Annuity Products

Different tax treatment of similar investments creates the incentive to take advantage of those differences. One of the issues in the recent discussions of leveraged buyouts is the extent to which tax considerations might influence those buyouts. Since interest paid on debt is deductible from corporate income and dividends paid to equity holders are not, incentives may exist to refinance some of a company's equity with debt. Incentives can be set up to use financial instruments having many of the characteristics of equity, but which are treated as debt instruments for tax purposes.

These incentives have also been an ongoing problem in the area of capital gains taxation. Due to the favored tax treatment, it always paid to get income declared as a capital gain rather than as regular income. Even after the Tax Reform Act of 1986, which rescinded the favored tax treatment of realized capital gains, the favored tax treatment of accrued capital gains remains.

The tax preference granted to many forms of pensions and deferred compensation sets up incentives to take income in that form and to disguise current compensation as deferred compensation. These incentives require very complicated rules to ensure that what is supposed to be deferred compensation actually is used for that purpose. Complicated rules have been established in the tax code, for example, on distributions from funds and trusts set up to finance deferred compensation or on loans that use deferred compensation as collateral.

Similar problems arise with life insurance and, to a lesser extent, with annuity products. Because of the tax-favored nature of life insurance, there are incentives to develop a product that looks like life insurance or can be defined as life insurance for tax purposes. Yet this practice allows people to shelter income from taxation and may, in fact, allow use of that sheltered income on a current basis. To deal with this problem, Congress set up two tests to define life insurance. These tests were established first, on a provisional basis, in the Tax Equity and Fiscal

[9]These loans must be repaid within 5 years, unless they are used to finance the borrowing employee's principal residence.

Responsibility Act of 1982 and then, on a more permanent basis, in the Deficit Reduction Act of 1984.

Under the law, a contract is considered life insurance if it satisfies either of two alternative tests. Under the cash value accumulation test, a life insurance contract's cash value cannot exceed the net single premium needed to pay all future benefits. Under the guideline premium limitation and cash value corridor test, the premiums cannot exceed certain guideline levels, and the death benefit cannot be less than a set proportion of the policy's cash value based on the age of the insured.

These tests may or may not have had the desired effect on life insurance products that involve more than one large upfront premium, but they did not appear to effectively limit the use of single premium life insurance products for investment purposes.[10] As a result, Congress further narrowed the definition of life insurance in the Technical and Miscellaneous Revenue Act of 1988. The act created a new category of products called "modified endowment contracts"—any policy funded at a more rapid rate than seven annual premiums. The act required that loans or other amounts received from these contracts would be taxable to the extent of the interest that had built up inside the policies. Thus, single premium policies would be classified as modified endowment contracts, and loans from them would be taxable.

This restriction appears, at least for the present, to have cut into the sales of single premium life insurance. Table 3.5 presents the premiums earned on single premium and other ordinary life insurance from 1984 through 1988. As a percentage of disposable income, premiums on single premium insurance rose substantially from 1984 to 1987 but fell by over 50 percent in 1988 compared with 1987.

[10]For a more detailed discussion of the use of single premium policies to get around the definitional tests, see Tax Policy: Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR, Oct. 16, 1987,) and Tax Policy: Mortality Charges on Single Premium Life Insurance Should Be Restricted (GAO/GGD-88-95, June 14, 1988).

Table 3.5: Premiums Earned on Single Premium and Other Ordinary Life Insurance

Dollars in millions

	Single premium insurance		Other ordinary insurance	
Year	Premiums	Percent of disposable income	Premiums	Percent of disposable income
1984	$1,032	0.04%	$37,593	1.41%
1985	2,470	0.09	43,626	1.54
1986	5,013	0.17	46,605	1.54
1987	9,436	0.29	52,698	1.64
1988	4,800	0.14	53,217	1.53

Preliminary data from the Life Insurance and Marketing Research Association (LIMRA) that are based on a sample of companies suggest that single premium policy premiums have fallen in the first three-quarters of 1989 to less than 30 percent of their value for a similar period in 1988. Recently, however, several new products have appeared that comply with the 1988 act but may not be in the spirit of that act.

It is more difficult to analyze whether other investment-oriented life insurance products are growing and at what rate. Data exist on the sales of variable life insurance, universal life insurance, and universal variable life insurance.[11] Other than the legal definition, no criteria exist for distinguishing which of these types of policies may be "too investment-oriented" from those that are not. As a result, we cannot precisely evaluate the implications of the preferred tax treatment on any investment-oriented policies that satisfy current law.

New Products and New Uses of Traditional Products

The life insurance industry has become a major competitor in the financial services industry. As a result, new products and new uses of standard products are constantly appearing. One example of a new product would be what is called a "combination plan." This includes an immediate annuity with a life insurance policy involving 10 annual premiums. The annuity pays the 10 premiums, but the policy qualifies as a life insurance product even under the new restrictions and, as a result, allows borrowing.

[11]Variable life insurance is a form of insurance that allows the policyholder to invest his or her cash value in a mutual fund, with the cash value reflecting the earning experience of that fund. Universal life insurance allows the policyholder to change the death benefit and the premium payments. These policies also explicitly distinguish mortality charges and interest rates that affect the policyholder's account. Universal variable offers the policyholder a choice of funds for investing the cash value, as well as a flexible payment schedule.

Another new product that especially interested Congress is a policy that insures two lives, only pays after the second death, and involves seven annual premiums (the minimum required under the 1988 law). This product also features a substantial reduction in the death benefit in the eighth year. The high initial death benefit allows the policy to qualify as life insurance, but the reduction in death benefits after the seventh year frees up more funds for investment purposes.

Both of these products appear to be attempts to comply with the 1988 act while keeping the main features of single premium policies that the law intended to curb. Congress dealt with the second product, the 7-year joint policy, in the recently passed Omnibus Budget Reconciliation Act of 1989. As a result of this change, any reduction in the death benefit below what ruled over the first 7 years of the policy requires a recalculation to see if the policy still qualifies as life insurance under the definition.

Examples of new uses of traditional products include "living benefits" policies and corporate-owned life insurance. Policies that involve living benefits pay out some designated part of the death benefit while the insured is still alive, if certain specified conditions are met. These conditions can include the onset of some specific illness, the certification of a terminal illness, or the entrance into a qualified nursing home. While there is little difference between borrowing against a policy and taking a living benefit, the conditions on the latter are much stricter and the amounts limited although funds are available sooner.

Many companies insure themselves against the loss of key individuals (individuals whose death would be costly to the company). Recently, a new type of corporate-owned life insurance has appeared that involves smaller amounts of insurance but for larger numbers of employees. The available data on this phenomenon are quite limited. Currently, only a few companies sell these policies, so the sample size is quite small. As a result, the amounts fluctuate from year to year and conclusions are difficult to draw. For example, LIMRA reports that for a sample of companies, the number of corporate-owned policies rose by about 70 percent, while the average face value of these policies actually fell from about $129,000 to about $57,000 per policy between 1987 and 1988. Comparing the first three quarters of 1989 with a similar period in 1988 but for slightly different samples shows a 33-percent increase in the number of policies, while the average face value rose from $65,000 to $249,000 per policy. These policies do not appear to be purchased for the employee or

the dependents of the employee. The company is generally the beneficiary named in the policies; in many states, the employees may not even know that they are insured.

While key person life insurance policies were used in the past, policies that involve large numbers of employees do not appear to insure against the loss of particular persons and the economic loss that would be suffered by the company with their deaths. Rather, the companies appear to be using the tax-deferred inside buildup and the death benefits to shelter income needed to finance currently unfunded liabilities, such as those incurred for future health benefits. This practice may be, in part, a response to a new set of accounting rules promulgated by the Financial Accounting Standards Board that would require the costs of future liabilities on retiree health benefits to be accounted for on a current basis. In addition, the borrowing privileges allow use of the funds to finance current activities. At present, this type of policy appears to be limited to a few companies. Because health benefits for retirees are projected to grow very rapidly, this method of funding could become more widespread.

Implications of Not Taxing Life Insurance Borrowing

Single premium life insurance policies were a source of concern not only because of the rapid buildup of interest inside the policy, but because they offered the potential for significant future borrowing against that inside buildup. As was discussed earlier, the policy loan is the one aspect of a life insurance policy whose tax treatment differs substantially from that of other deferred compensation items.

If the interest rate charged on a policy loan is low compared to market interest rates, a simple and profitable opportunity exists for the policyholder to borrow the inside buildup at the lower policy rate and reinvest it in something that earns a higher rate. No tax is assessed on such a transaction. Something like this appears to have occurred in the United States between 1965 and 1982. In 1965, policy loans outstanding were about $7.7 billion (less than 5 percent of life insurance industry assets). In 1982, policy loans were $53 billion (about 9 percent of industry assets).

In recent years, the difference between the interest rate charged on policy loans and rates that can be earned on investments has narrowed. As a result, outstanding policy loans have not increased, and as a proportion of assets, they have decreased to about 5 percent. However, each year an amount in the range of $9 to $12 billion is borrowed from life

insurance policies. In addition, the stock of outstanding policy loans still represents about 20 percent of the industry's ordinary life insurance reserves.

One aspect of certain single premium policies that drew attention was that they offered zero net-cost policy loans. The companies offered these loans by crediting to the policy an interest rate that was the same as that charged on the loan. This practice allowed policyholders the option of borrowing the interest accumulation without tax and without any requirement to pay back the loan. The concern generated by investment-oriented life insurance products in general, and single premium policies in particular, led to the introduction of the Stark-Gradison bill in 1987. The bill would have taxed loans from life insurance policies as distributions in a manner that parallels the treatment of deferred annuities. The staff of the Joint Committee on Taxation estimated that this would have raised about $700 million over a 3-year period.

Rather than enact the Stark-Gradison bill, which would have affected a broad range of policies, Congress chose to restrict its attention to single premium policies. Under the Technical and Miscellaneous Revenue Act, Congress put limits on the ability to borrow against single premium policies by defining a class of product that was not considered life insurance for tax purposes. This definition excluded any policies that involved fewer than seven annual level premiums. As noted earlier, new policies are being developed that may get around these rules. This circumvention is one of the weaknesses of the definitional approach. If sales of these new products become substantial or if the amount of borrowing from existing policies grows significantly, Congress may find it necessary to tackle the issue of borrowing more directly.

Past Changes in Tax Law Hurt but Recent Changes May Have Helped Sales of Deferred Annuities

As a result of changes enacted in the Tax Equity and Fiscal Responsibility Act of 1982, borrowing against deferred annuities is presently considered a taxable distribution. In addition, if that borrowing comes before the policyholder is age 59-1/2 or does not meet certain other conditions, a penalty tax of 10 percent is added. As we can see from table 3.6, this change may have led to a small drop in annuity sales between 1982 and 1983. However, since then, these sales have resumed their upward trend. Over the 9-year period covered by table 3.6, the sale of individual annuities increased substantially faster than after-tax income, while the premiums on individual life insurance rose at about the same rate. There are many possible reasons for this increase in annuity sales. Since the Tax Reform Act of 1986 narrowed the limits on

IRAs and other tax-preferred deferred compensation items, annuities have become more attractive. An additional source of funds moving into deferred annuities may be funds that would have gone into single premium life insurance before the limitations were enacted.

Table 3.6: Sales of Individual Annuities

Dollars in millions

Year	Individual annuity considerations	Annuity considerations as percent of after-tax income	Individual insurance premiums as percent of after-tax income
1980	$6,296	0.33%	1.54%
1981	10,290	0.48	1.62
1982	15,196	0.67	1.70
1983	14,003	0.58	1.56
1984	15,706	0.59	1.45
1985	20,891	0.74	1.62
1986	26,117	0.86	1.71
1987	33,764	1.05	1.94
1988	43,784	1.26	1.67

Preliminary indications from LIMRA, based on a sample of companies, suggest that sales of annuities have continued to rise in 1989, though at a slower rate than in recent years.

The Inside Buildup Debate

The issue of how to treat the inside buildup of life insurance and annuity products has been debated for decades. One argument for keeping the present tax treatment is that there is no special treatment because no personal income is truly available in an ongoing life insurance policy. Other arguments acknowledge the income but suggest that there are good policy reasons for granting special treatment.

To those who favor full taxation, the fundamental issue is that inside buildup is income that should be taxed on a similar basis as other earned income. Other arguments in favor of taxing inside buildup generally point to evenhanded treatment across financial instruments and institutions or the idea that particular social goals can be better achieved with more careful targeting of tax preferences or government spending.

Inside Buildup Is Income

Economic income for a household is defined as the sum of its consumption spending plus the change in its net worth over a period of time. According to this definition, the interest that accumulates on a life insurance policy is income—though income that may not be received in cash. As interest accumulates on a life insurance policy, other income is not needed to provide for future needs, thus freeing up these other resources for current use.

Unless some or all of the policy is surrendered or an annuity or loan received, no cash income is available to the policyholder. One reason for not taxing the accrual is that no actual cash flows to the policyholder or annuitant in the absence of some realization, such as surrendering a policy. Someone may be subject to a tax without having sufficient funds to pay the tax. This issue arises in the related context of taxing accrued capital gains. Taxpayers might incur such large capital gains and subsequent taxes that they would be forced to sell the assets to pay the taxes.

A related argument of life insurance companies is that they are trustees for their policyholders, and thus, the interest that builds up is not really owned by the policyholder or annuitant. While certain charges are imposed on early surrender, the policyholder has access to the funds through (1) fully or partially surrendering the policy or (2) borrowing the funds. The annuitant can take funds out of the annuity, borrow funds from the annuity, or liquidate the annuity. Even if the policyholder or annuitant does not exercise the option of gaining cash, this does not mean that the interest accrual is not income, only that it is not cash income.

Taxing the interest accruing on whole life insurance policies or annuities would be similar to the current taxation of interest accruing on certificates of deposit (when the interest is reinvested in the certificate) and original issue discount bonds. In both cases, the income is taxed even though no cash is received to pay the tax. Inside buildup is more like accrued interest than it is like accrued capital gains. Measuring accrued capital gains, in the absence of a sale of the asset or similar assets, may be a problem. In addition, capital gains are much more volatile and can increase or decrease substantially from year to year. Inside buildup is a steady, measurable increment each year.

Similarly, the prospects for taxpayers not having enough cash to pay a tax on accrued inside buildup should not be greater than currently exists for the tax on accumulating interest income. In both cases, funds may be withdrawn, if necessary, to pay the tax. In addition, inside buildup is unlikely to generate such a large taxable amount that an individual would be forced to surrender a policy to pay the tax. For example, a 45-year-old with a $100,000 life insurance policy that was purchased at age 25 and is accumulating interest at 5 percent would generate interest income of about $850 in that year. In 1984, Treasury estimated that the average annual inside buildup, for those with cash-value life insurance policies, was about $355 per family in 1983.

We believe that inside buildup is income and could be taxed without any more hardship than that imposed by the tax on other forms of interest income.

Tax Preference May Encourage Saving Through Life Insurance Companies but Has Little Effect on Total Saving

Because inside buildup is not subject to current taxation, the rate of return to saving through the life insurance policy or deferred annuity is likely to be higher than if this interest were subject to tax. Whether the rate of return is higher or lower than the after-tax return provided by other savings alternatives is uncertain. Because part of the premium goes toward purchasing insurance protection, the rate of return for life insurance is not as high as it would be if all of the resources were accumulated. As a pure investment vehicle, standard whole life policies are not very attractive. However, since they provide insurance protection along with the investment potential, they can be quite attractive.

If inside buildup were subject to current taxation and this, in turn, reduced the rate of return on life insurance and annuity products, the amount saved through the life insurance industry would probably be reduced. However, total saving is not likely to be affected very much.

The effect on total saving would depend upon whether the funds that moved out of the life insurance industry were spent or saved elsewhere. Alternative savings instruments are available other than whole life insurance or deferred annuities to provide for dependents or for one's own retirement. While some funds may be consumed, it is likely that a substantial part will remain as savings.

One last argument for saving through life insurance is the so-called "forced saving" argument. People may know that they would like to save a particular amount or a particular proportion of their income. However, they may also believe that if they make decisions on how much to save or consume on a monthly basis, they will always consume more than they "should." As a result, they might lock themselves into a savings plan that will require them to save some amount each pay period or, at least, make it very difficult to not save some amount each period. If this forced saving component is important and no alternative vehicles exist for forced saving, moving funds out of the life insurance sector could reduce total savings.

Since it is very difficult to quantify the extent to which life insurance saving is "forced," it is difficult to evaluate the importance of the "forced saving" argument. In addition, other ways are available that allow people to force themselves to save, such as retirement plans and payroll deduction devices. The net effect on total savings of reducing forced saving through life insurance is, therefore, unclear.

Tax Preference Increases Long-Term Capital Formation Financed by the Insurance Sector but Not for the Entire Economy

As a major financial intermediary, the life insurance industry provides a service by lending for a longer time than it borrows. It provides long-term financing to those who borrow funds from the industry. At the same time it provides insurance or annuities along with a certain amount of liquidity to its lenders who are the policyholders and annuity owners. This liquidity allows these lenders to receive cash, should they need it, without being forced to sell other assets and potentially suffer a substantial capital loss.

However, other financial institutions provide similar financial services. To argue for special tax treatment for the life insurance industry relative to other financial institutions, it is necessary to argue that the insurance industry is better at allocating invested funds from society's standpoint than are these other institutions. If the insurance industry were more efficient and profitable, ensuing returns would reflect this and the market would provide more funds to the industry without a

need for subsidy or tax preference. If the benefit to society is that the life insurance industry takes a long-term perspective or that its investments generate extra returns to society, there would be no reason to restrict the tax preference to whole life insurance policies or deferred annuities. The argument for some form of tax preference would also hold for term insurance, immediate annuities, or any other product sold by the life insurance industry. The purpose of the tax preference would be to get more funds into the hands of more efficient investors and not to limit the preference to only a subset of products.

Overall, no evidence suggests that investment by the life insurance industry is in any way more socially beneficial than the investment of other financial intermediaries. Because inside buildup is not taxed as current income, life insurance companies attract more funds for investment at the expense of other financial institutions whose interest payments are taxable to the depositor. Since there does not appear to be any clear evidence that life insurance companies are more efficient investors than other institutions, too many resources may be invested in life insurance companies and too few in other institutions.

Insufficient Provision for Beneficiaries' Future Needs Provides Primary Support for Tax Preference

The primary purpose of life insurance is to replace income lost due to the death of the insured. There are a number of reasons why the amount of insurance purchased may not be adequate for the purpose. If a family has a low income, for example, it may be very difficult for the family to put money aside to provide protection for dependents in case the primary earner dies. Families with below average income might underpurchase life insurance, and dependents in these families could, as a result, be underprotected. However, this does not appear to be the case.

In the ownership study done by LIMRA for 1984, 69 percent of households with incomes under $15,000 owned life insurance compared with 81 percent of households at all income levels. While the percentage of low-income households covered was below average, the amount of coverage by those households with insurance was above average. Households with incomes below $15,000 had coverage that was about 2.8 times annual income, while the average for all households was about 2.5 times income. While fewer low-income families purchase life insurance, the amounts they purchase—in relation to their income—tend to be larger.

In order for the special tax treatment of inside buildup to provide lower cost insurance to low-income households, the individual involved must at least be a potential taxpayer. If the individual's income is low enough, there will be no tax liability and, therefore, the tax break will be useless. The greatest benefit from this tax break would go to those in the highest marginal tax brackets, and these are not low income households. For example, Treasury reports that in 1983 fewer than 25 percent of families with incomes of $15,000 per year or less had life insurance of the type involving inside buildup.[1] This compares with 42 percent of families at all income levels who owned this type of insurance.

In addition, a major source of replacement for the lost income of low-income groups comes in the form of survivors' benefits paid by the Social Security Administration. As is true of all Social Security benefits, lower income groups get a better return for their contributions than do higher income groups. Some evidence shows that these benefits have reduced the amount of life insurance in force (the total face value of existing life insurance policies), though how much effect it has had on low-income groups is unclear.

Other concerns about the adequacy of life insurance protection have less to do with household income. One important concern is that people do not have sufficient foresight to plan for the contingencies of the future. It is difficult to know how much income one will have in the future, and how many people will be dependent on that income. While additional insurance can usually be purchased, it is generally more expensive the longer the delay. It may be difficult to know how much insurance is required to allow dependents to maintain a particular standard of living due to changes in inflation rates and other macroeconomic changes. Also, since most life insurance is purchased by the insured rather than by the potential beneficiary, dependents may find that the amount of insurance purchased is insufficient for their needs.

Although a number of studies have been done on the adequacy of life insurance coverage, the evidence regarding the adequacy of this coverage is inconclusive. One study indicated that low-income groups had adequate protection—at least as defined by the study and for the period examined—as a result of both purchases of life insurance and the Social

[1]Tax Reform For Fairness, Simplicity, and Economic Growth, Vol. 2 Department of the Treasury, November 1984, p. 262.

Security system and that higher income groups also had sufficient protection. A broad range of middle-income people, however, did not appear to have adequate coverage.

According to an ownership study by the Life Insurance Marketing Research Association, middle-income families with life insurance had protection that averaged about 2.4 times their annual income. This ratio is less than the coverage ratio recommended by some industry authorities, which was 4 to 5 times annual income. In addition, since about 90 percent of middle-income households had life insurance, for all middle-income families, the ratio of life insurance coverage to annual income was closer to 2. A more recent study indicates that coverage may be adequate when the costs and benefits of insurance are carefully computed. If the adequacy of existing coverage is difficult to evaluate, it would be even more difficult to estimate the effect that taxing inside buildup would have on life insurance coverage.

Policy Loans Defeat Purpose of Life Insurance and Should Be Taxed

Outstanding policy loans reduce the value of a life insurance policy's death benefit; thus, loans not paid back before the death of the insured defeat the purpose of life insurance. Because the company cannot force the policyholder to repay the loan—it is after all the policyholder's money—loans could be restricted or considered realizations of income first and considered principal second. This practice would make the tax treatment of life insurance consistent with that of other forms of deferred compensation, including annuities. However, restricting the ability to borrow against policies may reduce the demand for those policies. If existing life insurance coverage is inadequate, this could make that coverage even less adequate.

In 1988, Congress restricted borrowing on certain types of life insurance policies. One purpose of these restrictions was to limit the potential for borrowing on single premium life insurance policies at zero or very low rates. Congress imposed the restrictions not by explicitly limiting the ability to borrow against life insurance but by altering the definition of what constitutes life insurance. The effect was to create a type of policy with very restrictive borrowing privileges, much like those of annuities.

While these changes limited borrowing on policies with fewer than seven annual premiums, they did not directly deal with the broader problem of borrowing against the cash value of any whole life policy. This borrowing is the one tax advantage that life insurance retains over other forms of deferred compensation. In this way, the life insurance

industry could be said to have a tax advantage over other industries offering deferred compensation instruments.

Conclusions

By not taxing the inside buildup on life insurance and deferred annuities, the federal government forgoes $5 billion a year in potential tax revenue. While imposing a tax on the inside buildup could pose cash flow problems for some taxpayers because they will be taxed on income that they have not yet received in cash, the buildup is income and therefore could be part of the income tax base.

The only reason for not taxing inside buildup that we found to have merit is that doing so would reduce the amount of life insurance coverage that some people buy. Protecting survivors against income loss is a goal that society has traditionally supported. The primary question then is whether the increased revenue generated from taxing inside buildup would outweigh the costs to society of reduced insurance protection, including the possibility of direct government provision of income protection for dependents. Because patterns of life insurance ownership and the types of products available can change, Congress may wish to periodically reexamine its policy decision to forgo taxing inside buildup, weighing the social benefits against the revenue loss.

It may be preferable to give the tax advantage to those who would substantially reduce their coverage in the absence of the tax advantage, and not give the advantage to those who would purchase sufficient insurance even without the incentive. Unfortunately, it is very difficult to provide a targeted incentive for something that would not have occurred without the incentive and not to provide incentives for activities that would have occurred anyway.

High-income people would probably be able to protect their dependents without any tax preference and lower income groups are usually protected by Social Security benefits. In Tax Reform for Fairness, Simplicity, and Economic Growth, the Treasury Department proposed a way of limiting the tax preference for inside buildup by including the cash value of life insurance within the IRA ceiling. Others have proposed limiting the amount of tax-deferred interest that a taxpayer may claim. Restrictions such as these, though possibly cumbersome and difficult to administer, are feasible and would probably save the federal government some revenue. We have not done any analysis of the relative costs and benefits of such restrictions and, as a result, cannot evaluate these proposals. Congress may wish to examine this area if it chooses to

revisit the policy decision to grant preferential tax treatment to inside buildup.

The effect of this special tax treatment on the national savings rate is ambiguous. While the after-tax rate of return on funds invested in life insurance and annuity products is probably higher than it would be if taxable, it is not clear that it is higher than after-tax rates on taxable instruments that do not provide insurance or annuity protection. Even so, the effect of after-tax rates of return on saving is, in general, not clear. Only if a substantial amount of the saving is "forced" is there likely to be much in the way of additional saving. No evidence shows that the life insurance industry is any better than any other segment of the financial sector at making efficient investment decisions.

The inside buildup on life insurance and deferred annuities is treated similarly, under current tax law, as long as the funds remain in the product. However, tax law treats funds that are withdrawn or borrowed from a life insurance policy differently from funds withdrawn or borrowed from an annuity. The proceeds of a life insurance policy can be borrowed unconditionally and without tax, while the proceeds of deferred annuities can only be borrowed if a tax and a penalty are paid. Other deferred compensation instruments allow borrowing without taxation only under certain stringent conditions, otherwise a tax and penalty are imposed.

Until now, Congress has chosen to deal with concerns about potential misuse of the tax preference associated with inside buildup by narrowing the definition of what qualifies as life insurance. The definitional approach involves two dangers. First, the definition may not be narrow enough. Policies may qualify that are primarily oriented toward producing investment returns rather than insurance protection. Second, the definition could be too narrow. Products serving a legitimate life insurance need may be disqualified.

An alternative to the definitional approach would deal with the concerns more directly. Taxing the accumulated interest would remove the need for defining life insurance in the tax code, since there would no longer be any advantage to qualifying as insurance. The effect of this would be an extreme version of the overly strict definitional approach—that is, the tax preference would not be available for products that serve a legitimate life insurance purpose. An alternative would be to limit or eliminate the ability of policyholders to gain access to their

inside buildup without paying a tax. Taxing or placing limits on borrowing is a way of achieving these goals.

The ability to borrow against a life insurance policy is an attractive feature. Limitations on that feature may cause some buyers to reconsider the amount of life insurance that they wish to purchase. Unlimited borrowing allows the policyholder access to income without paying any tax and reduces the death benefit. Thus, we believe that borrowing against life insurance proceeds should be considered a realization of income subject to tax. The buildup is no longer inside the policy, and the basis for tax deferral no longer exists. If this serves to reduce borrowing, death benefits will be protected against what could be perceived as shortsightedness on the part of the policy owner. If it does not reduce borrowing, income will be taxed as it is realized. An added advantage of taxing life insurance borrowing is that it would reduce the incentive to construct life insurance policies, like single premium life policies that were designed for investment and not insurance purposes. Since repayment of borrowed amounts restores the death benefits, any amount that was included in taxable income when borrowed should be deductible if and when repaid.

Recommendation

Because the pattern of policy usage as well as the type of products offered can change, Congress may want to periodically reconsider its policy decision to grant preferential tax treatment to inside buildup, weighing the social benefits against the revenue forgone.

If Congress decides not to tax inside buildup, then GAO recommends that Congress eliminate tax-free borrowing of life insurance proceeds. Any borrowing of these proceeds should be considered a distribution of interest income. To offset the advantages of accruing interest income without tax, a penalty provision needs to be added to the regular tax. Since repayment of the amount borrowed restores the death benefits, any amount that is taxed when it is borrowed should be tax deductible if subsequently repaid.

Comments

GAO obtained oral comments from industry representatives on this report. Industry representatives stated that in their opinion, the current tax treatment of inside buildup is justified. They believe that recent changes in the tax laws have remedied serious abuses. They said that traditional life insurance products are not overly investment-oriented, although some of the single premium policies may have been. The

changes made in 1988, however, effectively closed any loopholes. In their view, loans are a legitimate part of the life insurance product and are generally used to serve important social goals, such as financing a home or paying college tuition. Therefore, there is no need to place any restrictions on these loans.

Calculation of Excess Premiums on Whole Life Insurance

Excess premiums arise in the early years of a whole life insurance policy because the annual premium is greater than the cost of the actual insurance coverage. As shown in chapter 2, the excess premiums are invested by the insurance company and earn interest income for the policyholder; the sum of the excess premiums and interest income built up is a policy's cash value. The face value less the cash value is the amount of actual insurance coverage provided by the policy for that year. The premium paid less the cost of the actual insurance coverage for a given year equals the excess premium for that year. The cost of the actual insurance coverage for a given year is the premium that would have to be paid for a 1-year term policy giving the same coverage. Table I.1 shows how the excess premiums grow in the early years of a policy, when the cost of the actual insurance coverage is less than the premium, and then become negative as the cost of the actual insurance coverage becomes greater than the premium. The calculations are based on the $100,000 annual premium whole life policy presented in chapter 2.

Table I.1: Calculation of Yearly and Cumulative Excess Premiums on a $100,000 Annual Premium Whole Life Policy

Age	Annual premium	Actual insurance coverage	Cost of insurance	Annual excess premium	Cumulative excess premiums
25	$676	$99,466	$168	$508	$508
35	676	92,381	186	490	5,609
45	676	82,095	356	320	9,699
55	676	68,509	683	(7)	11,326
65	676	52,344	1,191	(515)	8,335
75	676	35,759	2,186	(1,510)	(2,169)
85	676	22,243	3,240	(2,564)	(22,936)
95	676	10,717	3,368	(2,692)	(51,258)
99	676	0	0	0	(58,557)

The annual excess premium begins at $508 at age 25 and declines gradually over the years until it turns negative at age 55. At this age, the cumulative excess premiums reach a maximum of $11,326. After age 55, the cost of the actual insurance coverage is greater than the annual premium, and the annual excess premium turns negative. At this time, the cumulative excess premiums are used to supplement the annual premium. By age 75, however, the cumulative excess premiums are used up; the inside buildup (interest income) is then used to supplement the annual premium in order to cover the cost of the actual insurance coverage.

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