THE TAX EXPENDITURE FOR LIFE INSURANCE INSIDE BUILDUP

Life insurance contracts often have a savings component. The accumulated income earned on this savings component is referred to as "inside buildup." In contrast to the income earned on many savings vehicles, e.g., bank deposit accounts and bonds, inside buildup is not taxed as it accrues. If inside buildup is ultimately distributed as death benefits, or used to reduce the cost of insurance coverage, the income is never subject to tax. If instead, inside buildup is ultimately distributed to policyholders who cash in their insurance policies, the inside buildup is taxed, but that tax payment is deferred.

The exclusion and deferral of earnings on life insurance policies is treated as an official tax expenditure in the President's Budget and, until recently, as an official tax expenditure published by the Joint Committee on Taxation (JCT). Indeed, inside buildup is one of the original tax expenditures identified by Stanley Surrey and the Treasury Department.[1] It is also one of the largest tax expenditures, with a ten-year revenue cost estimated at over $370 billion.[2] However, starting with their 2015-2019 estimates, the JCT staff no longer includes the deferral or exclusion of life insurance inside buildup as a tax expenditure.[3] The JCT reclassification offers an opportunity to review the nature of the tax expenditure for inside buildup.

Tax expenditures are defined and measured by comparing the revenue associated with specific items under current tax law with their treatment under a "normal," or "baseline," tax system. However, there is not universal agreement on how to define this baseline tax system. In addition, the 1974 Budget Act,[4] which guides the official tax expenditures prepared by the Treasury and the JCT, does not identify the baseline tax system to be used to construct a tax expenditure budget. Instead, the Budget Act defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[5] No guidance is given on what represents a "special" tax rule. As a result, there is some leeway in defining the baseline tax system and, hence, in defining those provisions of current law that are, and those that are not, official tax expenditures.

Both Treasury and the JCT use baseline tax systems that are informed by the conceptual model of "economic income," under which net income is measured as the change in a taxpayer's net wealth over an accounting period, plus his or her consumption during that period. However, the JCT and Treasury staff use judgment to modify this baseline to include certain elements of current law that are not necessarily consistent with a strict interpretation of the concept of economic income.[6] Often, these modifications seem to be motivated by concerns over administrability or practicality, in

[1] U.S. Department of the Treasury (1969) *Annual Report of the Secretary of the Treasury on the State of the Finances for Fiscal Year 1968*, Document number 3245, p. 335.
[2] This estimate includes the deferral of tax on earnings of annuity contracts, in addition to life insurance contracts. U.S. Office of Management and Budget (February 9, 2016) *Budget of the United States Government, Fiscal Year 2017, Analytical Perspectives,* Table 14-3 (hereinafter cited as *Analytical Perspectives* (2016)).
[3] The Joint Committee on Taxation, JCX-141R-15 (December 7, 2015), Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019 (hereinafter cited as JCT (2015)).
[4] Congressional Budget and Impoundment Control Act of 1974, P.L. 93-344, 88 Stat. 297.
[5] Budget Act, §3(a)(3).
[6] JCT (2015), p. 2. Also see the discussion in *Analytical Perspectives* (2016), pp. 226-227.

addition to judgments about what distinguishes a "special" tax provision from a "general" tax provisions.

Under an economic income baseline, the exemption and deferral of inside buildup represents a tax expenditure. In general, the inside buildup is a component of an insurance company's "reserve." When viewed from the policyholder's viewpoint, the reserve is a component of the policyholder's wealth. An increase in the value of the reserve beyond the payment of a policyholder premium is an increase in the policyholder's net wealth. Hence, an increase in a policyholder's inside buildup is income to the policyholder, as it represents an increase in his or her net worth. One primary purpose of our paper is to review this point using a simple, stylized example of a life insurance contract.

After setting up our example and working through a comparison of current law with an economic income baseline, we turn to an analysis of JCT's reclassification. JCT's reclassification of inside buildup does not represent a change in its interpretation of "economic income," nor in its views about administrability, nor the distinction between "special" and "general" tax treatments. Rather, it appears to reflect a new emphasis on the phrase "provisions of the Federal tax laws" found in the Budget Act.[7] The JCT staff notes that because "no provision of the Federal tax law specifically allows an exclusion" of the investment income on life insurance contracts, there is no tax expenditure for the inside buildup of life insurance, despite the deviation from economic income that deferral and exclusion represent.[8]

Our analysis suggests that, contrary to JCT's conclusion, inside buildup represents a tax expenditure even if one accepts the JCT's interpretation of, and emphasis on, the phrase "provisions of the Federal tax laws" in the Budget Act. In this analysis, we accept the nonrecognition of inside buildup earnings as income to policyholders. We demonstrate that a tax expenditure can still be identified, arising from specific provisions of the Internal Revenue Code (IRC) that provide favorable tax treatment to both insurers and policyholders. These provisions include the IRC's exclusion of death benefits from gross income, and the Code's overly expansive definition of basis in a life insurance contract. In this context, the tax expenditure also arises from special IRC rules that allow life insurance companies to establish certain tax-deductible reserves, and, thus, to accrue expenses in a way that other corporations generally cannot. Eliminating these provisions, and so measuring the income and deduction flows under the normal corporate tax rules, would include all of inside buildup in the tax base, similar to what would occur under an economic income baseline. Thus, we conclude that it is possible to identify life insurance inside buildup as atax expenditure even under the JCT's revised interpretation of Budget Act.

Our approach looks at the taxation of the entire flow of inside buildup, in the same way that the JCT looks at the flow of income from owner-occupied housing in assessing the treatment of home mortgage interest. Viewed in isolation, the deduction for home mortgage interest is not a tax expenditure because economic accounting would allow a deduction for interest expense. However, the tax code does not include in taxable income the implicit rental value of the house (and this exclusion is implicit – there is no explicit statement in Federal tax law that says such income is to be

[7] JCT (2015), p. 20.

[8] Nevertheless, the JCT staff writes, "it may be appropriate to include a tax expenditure estimate of the exclusion from gross income of death benefits payable under a life insurance contract by reason of death of the insured." JCT (2015), p. 20. However, such a tax expenditure estimate has not been forthcoming.

left out of the tax base). As a result of this exclusion, the interest deduction is inappropriate because the income to which it relates is excluded from the tax base. Thus, considered in the context of the taxation of the entire flow of income from owner-occupied housing (i.e., conditional on excluding implicit rental income), the deduction for home mortgage interest represents a deviation from economic income and so is included as a tax expenditure by the JCT (even though the exclusion of the implicit rental income from owner-occupied housing is not). The same approach applies to the analysis of inside buildup: the tax rules identified above produce a tax expenditure when the corresponding income accruing to policyholders is excluded from taxation.

Examining these alternative interpretations of the sources of the exclusion is also relevant for informing tax policy to the extent there is interest in reducing tax expenditures in general or tax expenditures for life insurance in particular. One technical challenge in reducing the tax expenditure is the difficulty in assigning income to individuals from gains accrued within an insurance contract; similarly, the tax system rarely imposes tax on income not received in cash by the taxpayer. In contrast, because the tax expenditure could be considered to result from accounting rules and the deduction for life insurance reserves, and because the gross income is received or accrued by the insurance company, it may be more feasible and palatable to reduce the tax expenditure by changes to those features. We investigate this possibility further below.

Example Using a Cash-Value Life Insurance Policy

We employ a highly stylized life insurance example to illustrate how taxable income is determined under current law, under an economic income tax baseline, and under a modified normal tax law baseline. To simplify the presentation, no taxes are explicitly included in the example. Nevertheless, the tax implications can be inferred by examining reported taxable incomes. In order to focus on the issues at hand, we assume the insurance company faces no administrative costs and earns no profits or losses. Accordingly, all premiums and contract interest earnings are ultimately returned to policyholders or paid to policy beneficiaries.

The example assumes the purchase from an insurance company of 1,000 identical single-payment whole-life insurance policies covering the lives of 1,000 insured individuals of the same age and gender. Each owner of a policy, the "policyholder," pays a one-time single premium that, when invested by the insurance company, is assumed to be just sufficient to pay the future annual costs of life insurance protection (or "mortality costs") over the remaining life of the insured individual. These mortality costs are annual amounts each policyholder must contribute *a priori* to an insurance "pool" in order to fund the anticipated death benefits to be paid from that pool. We assume the mortality charges are assessed immediately prior to the company's payment of death benefits. The company's invested assets earn interest at an assumed rate of 5 percent.

The insurance company creates a liability account (a "life insurance reserve") for each contract. This reserve signifies that the company's invested assets are not available to its owners, but represent funds to be used to satisfy future (contingent) contract obligations. The reserve equals the net present value of the future mortality costs expected under the contract. In the example, this net present value is calculated using a valuation interest rate equal to the company's investment earnings rate. The reserve of each surviving policy tends to increase over time because future mortality costs approach the moment of valuation, and the amounts of their discounts due to interest consequently decline. The reserve tends to decrease over time as these mortality costs are incurred and thus no longer exist in the future. This description is equivalent to a statement that the reserve

of each surviving policy increases over time due to the crediting of interest earnings to the reserve, but is reduced by the annual mortality charges assessed against it.

Finally, in order to illustrate the tax treatment of direct distributions of cash out of life insurance policies, we assume that each policy has a cash surrender value and that there are no charges imposed upon policy surrenders. For simplicity, we also assume that a policy's cash surrender value equals the value of the policy's reserve. Thus, a policyholder may, at any time, surrender his or her policy for cash equal to the full value of the policy reserve.[9]

Policy Details

Table 1A presents the example's mortality and policy surrender assumptions for the first three years of the policy.[10] It shows policyholder counts at the beginning of each year, the number of deaths assumed to occur at the end of each year, the number of surviving policyholders, and the number of policies surrendered at the end of each year. A single insured is assumed to die at the end of each of the first three years. We also assume that all surviving policies are surrendered immediately after death benefits are paid at the end of year 3.

TABLE 1A

Policy Details

	Mortality and Policy Surrender Data			
	(1)	(2)	(3)	(4)
Year	Policyholders	Deaths	Survivors	Surrendered Policies
	BoY	EoY	EoY	EoY
1	1,000	1	999	0
2	999	1	998	0
3	998	1	997	997

Table 1B shows the individual policy financial data. Each policy has a death benefit of $1,000,000, and each policyholder pays a single premium of $26,344 at the beginning of year 1. The insurance company immediately creates a reserve for each contract in the amount of the premium, and annual interest is credited to the reserve using a five percent rate. Charges for mortality costs are debited annually against the reserve.[11] The relevant amounts for a reserve's credited interest and debited

[9] Inside buildup consists of the investment income credited to policy reserves or distributed to policyholders as a part of death benefits. It is not limited to policies having cash surrender values. For example, inside buildup is earned under term life insurance policies, but such policies do not possess cash surrender values. Equating cash surrender values with reserve values allows us to maintain our zero profit or loss assumption for the insurance company.

[10] In the tables, "BoY" refers to "Beginning of Year," and "EoY" refers to "End of Year," with each designation indicating the exact timing of the payment or receipt. All reported net present values (NPV) in Tables 2 through 5B refer to amounts computed as of the beginning of Year 1 using a discount rate of five percent. All reported results have been rounded to the nearest dollar.

[11] Because assets backing the reserves of policies with deceased insureds are also used to pay death benefits, the mortality charge equals the expected mortality rate for the current year, multiplied by the excess of the policy's death benefit over the amount of the policy's reserve, determined just after the assessment of the mortality charge and

mortality charges are shown in columns (2) and (3) of Table 1B, respectively. The individual policy reserve of a surviving policyholder as of the end of each year (but prior to any contract surrenders) is shown in column (4) of the table.[12]

TABLE 1B

Policy Details

	Financial Data			
	(1)	(2)	(3)	(4)
Year	Premiums	Interest Credited	Mortality Charges	Policy Reserve
	BoY	EoY	EoY	EoY
1	$ 26,344	$ 1,317	$ 973	$ 26,688
2	$ -	$ 1,334	$ 974	$ 27,049
3	$ -	$ 1,352	$ 975	$ 27,426

TABLE 2

Insurance Company Cash Flows and Assets

	(1)	(2)	(3)	(4)	(5)	(6)
Year	Premiums	Mortality Charges	Death Benefits	Cash Surrender Benefits	Interest Income	Insurance Company Assets
	BoY	EoY	EoY	EoY	EoY	EoY
1	$ 26,344,171	$ 973,312	$ 1,000,000	$ -	$ 1,317,209	$ 26,661,380
2	$ -	$ 972,951	$ 1,000,000	$ -	$ 1,333,069	$ 26,994,449
3	$ -	$ 972,574	$ 1,000,000	$ 27,344,171	$ 1,349,722	$ -
Sum	$ 26,344,171	$2,918,837	$ 3,000,000	$ 27,344,171	$ 4,000,000	NA
NPV	$ 26,344,171	$2,782,085	$ 2,723,248	$ 23,620,923	$ 3,629,558	NA

Table 2 describes the insurance company's cash flows and assets. The company collects $26,344,171 in premiums at the beginning of year 1, earns interest income of $1,317,209 in that first year, and pays $1,000,000 in death benefits, leaving accumulated assets of $26,661,380. Total mortality charges of $973,312 are assessed against the reserves of the 1,000 initial policyholders in year 1. This amount, when combined with $26,688 (representing the reserve of the policy with a deceased insured), is sufficient to pay the $1,000,000 death benefit in that year. Similar transactions occur in years 2 and 3. At the end of year 3, the invested assets remaining after the payment of the

immediately prior to the payment of the death benefits. Thus, for year 1, the contract mortality charge of $973 satisfies the following relation: $973 = (1/1,000) [$1,000,000 – ($26,344 + $1,317 – $973)]. Charges for years 2 and 3 are calculated in a similar manner.

[12] For each year, the change in the value of the policy reserve, shown in column (4) of Table 1B, equals the premiums received (column (1)), plus interest credited (column (2)), less the contract mortality charge (column (3)).

death benefits, but before any surrenders, amount to $27,344,171.[13] These assets are fully paid out as cash surrender benefits at that time. Thus, total distributions in the form of both death benefits and cash surrender benefits sum to $30,344,171. This amount represents a return of policyholder invested capital (that is, the premiums paid) of $26,344,171 and interest earnings of $4,000,000.

Current Tax Law

Under stylized current tax law, gross premiums are included fully in life insurance company gross income, and benefits paid to policyholders or their beneficiaries are deductible by the company. In addition, the life insurance company is allowed to establish life insurance reserves. Additions to reserves are deductible from income, while reductions are added to income. Also, under current law, contingent insurance benefits to be received in the future are not taken into account in determining policyholder income. Thus, life insurance reserves, which reflect those future benefits (and, in general, future premiums), do not represent equivalent policyholder assets, and inside buildup credited to those reserves is not recognized as policyholder income unless, and until, those earnings are actually distributed to the owners.[14]

Table 3A summarizes the accounting for the insurance company. In year 1, the insurance company recognizes premium receipts of $26,344,171 and interest income of $1,317,209 as gross income. Their sum is shown in the first row of column (2) of the table. The insurance company has an aggregate life insurance reserve of $26,661,380 at the end of year 1 that reflects the sum of the individual contract reserves for the 999 surviving policyholders. The addition to this aggregate reserve over year 1 is deducted from that year's gross income. The $1,000,000 death benefit paid in year 1 is also deducted. The sum of these deductions, shown in the first row of column (3) of the table, perfectly offsets total gross income, resulting in taxable income of zero. In year 2, interest income of $1,333,069 is reported as gross income; and deductions equal to $333,069 (the increase in the aggregate reserves) and $1,000,000 (the death benefit) are taken against that gross income, resulting in zero taxable income for year 2. Finally, in year 3, the insurance company recognizes interest income of $1,349,722 and pays out $1,000,000 in death benefits. In addition, the company liquidates its remaining assets of $27,344,171, and pays out cash surrender benefits to the 997 surviving policyholders. The resulting reduction in reserves of $26,994,449 is recognized as gross

[13] For each year, the change in the value of the insurance company's assets, shown in column (6) of Table 2, equals the premiums received (column (1)), plus interest income (column (2)),less death benefits and cash surrender benefits paid, shown in columns (3) and (4), respectively.

[14] This is true for accrual method taxpayers as well as for those using the cash accounting method. For accrual method taxpayers, the recognition of income requires that all events have occurred that fix the right to receive such income, and the amount can be determined with reasonable accuracy. For cash method taxpayers, tax accounting rules specify that income is recognized when cash is either actually or constructively received. But constructive receipt is not deemed to occur if the actual receipt of cash is subject to substantial limitations or restrictions. See reg. §1.451-1 and reg. §1.451-2. One might inquire whether the interest accretions of cash surrender values should constitute policyholder income. For policies that require the surrender of a policy in order to access its cash value, one might reasonably conclude that neither income recognition rule is satisfied, since access to the cash entails significant costs. Policies allowing partial withdrawals also impose costs, however. For example, the withdrawal of cash implies higher mortality charges going forward. In addition, under IRC §7702, a contract that fails to qualify as a "life insurance contract" for purposes of the IRC is taxed on the net earnings credited to the contract's net surrender value. This rule could be interpreted as a specific IRC provision that implicitly grants an exclusion for inside buildup on qualified life insurance contracts that is reflected in cash surrender values, since such income inclusions are not required for such qualified contracts. Also, the taxation of distributions of cash surrender benefits under IRC §72 make no sense unless the inside buildup is not taxed when credited to cash surrender values.

income for the company. However, the deductions for the payment of the cash surrender benefits and death benefits offset all gross income, resulting in zero taxable income for year 3.

TABLE 3A
Life Insurance Company Taxable Income Under Current Law

Year	(1) Life Insurance Reserves	(2) Gross Income (Premiums + Interest + Reserve Reductions)	(3) Deductions (Benefits Paid + Reserve Additions)	(4) Taxable Income
	EoY	EoY	EoY	EoY
1	$ 26,661,380	$ 27,661,380	$ 27,661,380	$ -
2	$ 26,994,449	$ 1,333,069	$ 1,333,069	$ -
3	$ -	$ 28,344,171	$ 28,344,171	$ -
Sum	NA	$ 57,338,620	$ 57,338,620	$ -
NPV	NA	$ 52,038,065	$ 52,038,065	$ -

Table 3B
Policyholder and Beneficiary Taxable Income Under Current Law

Year	(1) Aggregate Policy Basis	(2) Income From Death Benefits (Beneficiaries)	(3) Income From Cash Distributions (Policyholders)	(4) Policyholder and Beneficiary Taxable Income	(5) Total Taxable Income of All Taxpayers
	EoY	EoY	EoY	EoY	EoY
1	$ 26,317,827	$ -	$ -	$ -	$ -
2	$ 26,291,483	$ -	$ -	$ -	$ -
3	$ 26,265,139	$ -	$ 1,079,033	$ 1,079,033	$ 1,079,033
Sum	N/A	$ -	$ 1,079,033	$ 1,079,033	$ 1,079,033
NPV	N/A	$ -	$ 932,109	$ 932,109	$ 932,109

Table 3B summarizes the current law accounting for policyholders and beneficiaries. Distributions in the form of death benefits are generally excluded from the gross incomes of both policyholders and beneficiaries.[15] In addition, for the purpose of determining the income portion of distributions in the form of cash surrender benefits, policyholder basis is comprised of all premiums paid, without reductions for mortality charges.[16] Thus, mortality charges are effectively treated as

[15] IRC §101(a).
[16] IRC §72(e)(6). Under IRC §72(e)(5) there is a special "basis-first" rule that applies to cash distributions for most life insurance contracts. This rule treats distributions as a tax-free return of capital until basis is exhausted. Thus, partial

investment expenses (that is, a reduction in the net investment yield), rather than as tax-free distributions of cash to policyholders, which are then used to pay for annual life insurance protection. At the end of year 3, since three policyholders have died, there is an aggregate investment basis of $26,265,139. See column (1) of the table. Subtracting this basis from the $27,344,171 of cash surrender benefits leaves $1,079,033 as policyholder taxable income in year 3, as shown in column (3) of Table 3B. Column (4) of that table shows a like amount for the combined taxable income of policyholders and beneficiaries, while the final column shows the total taxable income under current law for all parties involved. Comparing this result with the interest earnings reported in column (5) of Table 2, shows that only $1,079,033 out of $4,000,000 of interest income is recognized as taxable income under current law. Income of $2,920,967 is permanently excluded from taxpayer gross incomes, while recognition of the reported income is deferred relative to when it was earned.

Inside Buildup under an Economic Income Tax Baseline

Table 4 summarizes the accounting for our example under an economic income tax baseline. Recall that, under this baseline, taxable income is measured by the change in a taxpayer's wealth during a year, plus the taxpayer's annual consumption. For the insurance company, premium receipts increase a company's assets and wealth.[17] Life insurance reserves are amounts set aside to pay future death benefits. Their increase over time represents an increase in a company's liabilities and a reduction in company wealth. In our example, these changes in wealth are exactly offsetting, so the payment of the initial premiums and the establishment of reserves do not result in an addition to life insurance company income. Interest is earned on company assets and credited to reserves, again resulting in a zero addition to company net income. Finally, deductions are made annually from the reserves for the payment of death benefits and cash surrender benefits. In both cases, assets and liabilities decline by the same amount with no change to company wealth or income. Column (1) of Table (4) reports the net taxable incomes for the insurance company under an economic income tax baseline.

The situation is quite different for policyholders and beneficiaries under the economic income tax baseline. At the onset of a contract, a policyholder exchanges cash for an insurance asset. This asset is measured by the net present value of future mortality benefits, and is equivalent in value to the company's contract reserve. In the example, the insurance asset equals the premium paid, so there is no change in the policyholder's wealth or income. However, during each year, the policyholder's life insurance asset increases in value as expected mortality distributions move closer to the present. The mortality charge is treated as a contract distribution to the policyholder, made from the policyholder's insurance asset. The company, acting as an agent of the policyholder, transfers the funds to an insurance pool, and, upon a death benefit claim, subsequently transfers those funds from the insurance pool to the beneficiary of the deceased insured. Once transferred from the policyholder to the insurance pool, the mortality charge is no longer a component of the policyholder's wealth, and therefore represents a reduction of policyholder income. An additional

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withdrawals of cash value, as opposed to complete surrenders, can result in no tax liability being incurred with respect to those distributions.

[17] References to insurance company income should be understood to refer to the income of the company's shareholders. Because a corporation is simply an asset of its shareholders, changes in corporate wealth arising from shareholder contributions of new equity and from distributions of corporate earnings to shareholders are ignored in measuring corporate shareholder income under an economic income tax baseline.

amount, equal to the reserve of the policy with the deceased insured, is also distributed to the policyholder, and then transferred from the policyholder to the beneficiary, lowering the policyholder's wealth and income. The net effect on policyholder incomes of the accretion to wealth from interest earnings, and the reduction of wealth from transfers to beneficiaries is shown in column (2) of Table 4. Thus, total policyholder income over the three-year period is $1,000,000. At the end of year 3, each surviving policyholder receives the cash surrender value of his or her policy. The value of the insurance asset drops to zero, offsetting the increase in the policyholder's cash and resulting in no additional change in policyholder wealth or income.

TABLE 4

Income Under an Economic Income Tax Baseline

	Insurance Company	Policyholders and Beneficiaries			All Taxpayers
	(1)	(2)	(3)	(4)	(5)
Year	Taxable Income	Change in Wealth (Policyholders)	Consumption (Beneficiaries)	Taxable Income	Total Taxable Income
	EoY	EoY	EoY	EoY	EoY
1	$ -	$ 317,209	$ 1,000,000	$ 1,317,209	$ 1,317,209
2	$ -	$ 333,069	$ 1,000,000	$ 1,333,069	$ 1,333,069
3	$ -	$ 349,722	$ 1,000,000	$ 1,349,722	$ 1,349,722
Sum	$ -	$ 1,000,000	$ 3,000,000	$ 4,000,000	$ 4,000,000
NPV	$ -	$ 906,310	$ 2,723,248	$ 3,629,558	$ 3,629,558

In each year, a single beneficiary's wealth increases by the amount of a $1,000,000 death benefit. To avoid the need to track future beneficiary investments, we assume that all death benefits are immediately consumed. Thus, beneficiary consumption expenditures, and beneficiary incomes, total $3,000,000 over three years under the economic income tax baseline, as shown in column (3) of Table 4. Summing policyholder and beneficiary taxable incomes in each year yields the amounts shown in column (4), which is identical to the total taxable income for all taxpayers shown in column (5). Comparing these values with those reported in column (5) of Table 2 shows that the economic income tax baseline yields annual aggregate taxable incomes equal to the interest earned on the company's invested assets in each year.

To summarize, the aggregate taxable income of policyholders and beneficiaries under an economic income tax baseline is the $4,000,000 of inside buildup earned over the three-year period. As it accrues, this income is attributed to policyholders and beneficiaries, as they are the ultimate claimants on the investment income. This result can be contrasted with that shown for total taxable income under current law in the final column of Table 3B. When valued using appropriate tax rates, the differences in the total taxable incomes reported in these two tables represent tax expenditure estimates for life insurance inside buildup in this example.

Inside Buildup under a Modified Normal Tax Baseline

As mentioned above, the JCT interpretation requires there to be "provisions of the Federal tax laws" that cause the tax expenditure. Arguably, the requirement that a tax expenditure must be the result of provisions of tax law is met by the traditional tax expenditure for inside build up. The tax expenditure is caused by the income recognition rules, which do not require policyholders to take inside buildup into income. If inside buildup were taken into income, then the other rules governing the taxation of life insurance companies and policyholders would (largely) work appropriately. In that scenario, the ability of insurance companies to reserve for future benefit payments under current law is fully consistent with an economic income tax baseline, since the inside buildup would be income to policyholders, not the insurance company. And the current-law exclusion of death benefits would not affect the total taxable income recognized because inside buildup would already have been taxed as it accrued. Current law's definition of investment basis in an insurance contract, if modified to reflect taxed inside buildup, would be immaterial, since cash distributions from a contract would represent previously taxed increments to wealth, and so would not be taxable.

An objection to this line of argument is that the tax code does not have a specific exemption for inside buildup per se. Rather, the exemption of inside buildup occurs because it is not in the non-exhaustive list of items included in gross income and fails to qualify as income under commonly accepted income recognition rules, notwithstanding that these rules deviate from economic accounting principles.[18] Thus, under this reasoning, inside buildup would not qualify as an official tax expenditure.

The problem with this reasoning is that, if one assumes a baseline in which inside buildup is non-taxable to the policy holder, then other rules—rules which are specific "provisions of the Federal tax laws"—misfire, and, rather than contributing to proper income measurement, actually impede it. Each provision, like the exclusion of inside buildup to policyholders, need not represent a deviation from economic accounting when considered in isolation. But when considering the transaction as a whole, these separate provisions of tax law combine to create an exclusion of inside buildup from the tax base. In this case, inside buildup would remain an official tax expenditure, but the source of the expenditure would not be the exclusion of income by policy holders.

An analogy might be made to the deduction for mortgage interest on owner occupied housing, which JCT considers to be a tax expenditure. Viewed in isolation, the deduction is not a tax expenditure because economic accounting would allow a deduction for interest expense. However, the tax code does not include in taxable income the implicit rental value of the house. Considered in the context of the taxation of the entire flow of income from owner occupied housing (i.e., conditional on excluding implicit rental income), the deduction for home mortgage interest represents a deviation from economic income.

As stated above, we accept the basic policyholder income recognition rules that allow them to exclude the accrual of inside buildup from taxable income. Policyholders only pay tax on (a part of) inside buildup when they cash in their policies. We do not count the exclusion directly as the

[18] See footnote 15.

tax expenditure, in the same way that the JCT does not count the exclusion of implicit rental income on owner occupied housing as a tax expenditure. We do, however, evaluate other tax rules in light of the failure to tax inside buildup as it accrues to policyholders, in the same way that the JCT evaluates the deduction for home mortgage interest in light of the failure to tax the rental income on owner occupied housing.

First, we look at the provisions that determine a policyholder's basis in an insurance contract to measure the taxable portion of any distributions from the contract. Those rules compute basis as premiums paid, and do not reduce basis for mortality charges. This treatment measures basis incorrectly. Mortality charges are essentially tax-free distributions to policyholders from contract reserves, and should reduce policyholder basis in those contracts. Next, we look at the tax-exemption of death benefits. The full exemption of these benefits also does not accord with proper income measurement to the extent that some of death benefits are distributions of untaxed inside buildup. This rule is not in keeping with the general tax principal that income should (eventually) be taxed. [19]

Finally, we turn to the provisions that allow insurance companies to take reserve deductions. While life insurance reserve accounting may properly measure insurance company income, in a system where policyholders pay tax on inside buildup as it accrues, such accounting contributes to the tax expenditure for inside buildup. Income for the tax system as a whole is incorrectly measured when the insurance company's deduction for interest credited to reserves is not matched by an offsetting income inclusion for the policyholder.

In our modified normal tax law baseline, we implement this analysis by reducing policyholder basis for mortality charges paid out of inside buildup; taxing death benefits to the extent paid from untaxed inside buildup; and taxing life insurance companies using rules available to other businesses. Under these rules the companies include interest earnings in their taxable income and deduct death benefits and policy redemptions by policyholders. Much like an economic income baseline, this modified baseline includes inside buildup as it accrues.

Tables 5A and 5B provide the accounting for the example under the modified normal tax law baseline that implements our changes to current law discussed above. Table 5A shows results for policyholder taxable incomes. Under the modified baseline, a policyholder is potentially taxed on a contract's investment income upon a distribution of cash, whether that distribution takes the form of cash surrender benefits or an amount that is subsequently transferred to beneficiaries as a component of death benefits. To measure that income appropriately, however, requires a correct measurement of the investor's cost or basis. Because mortality charges are not costs of investment, but rather represent tax-free distributions of invested amounts, they must be subtracted from premiums in order to correctly measure basis. Under this approach, a policyholder generally has an adjusted basis equal to the premiums paid on the contract, less untaxed distributions. Those distributions include mortality charges deducted from the policy reserve and other untaxed

[19] Death benefits are paid from two sources: mortality charges (treated as tax-free distributions of basis) and the contract reserves of policies with deceased insureds. Funds are deemed to be first distributed to the relevant policyholder (and potentially taxed), and then transferred to the appropriate beneficiary. IRC §102(a) generally excludes gifts from gross income, and we accept that this exclusion should apply to transfers of death benefits to beneficiaries.

withdrawals.[20] In the example, a policy's basis at the end of year 1 is $25,371 (equal to the initial premium of $26,344, less a first-year untaxed mortality charge of $973). Furthermore, after subtracting additional untaxed mortality charges, a surviving policyholder has a basis of $24,397 at the end of year 2 and $23,422 at the end of year 3. These amounts are shown in column (2) of Table 5A. They may be compared with the policy cash values taken from column (4) of Table 1B and repeated in column (1) of Table 5A.

TABLE 5A

Income Under the Modified Normal Tax Baseline

	Policyholders				
	(1)	(2)	(3)	(4)	(5)
Year	Contract Cash Value	Contract Adjusted Basis	Income from Death Benefits	Income From Cash Surrender Benefits	Taxable Income
			EoY	EoY	EoY
1	$ 26,688	$ 25,371	$ 1,317	$ -	$ 1,317
2	$ 27,049	$ 24,397	$ 2,652	$ -	$ 2,652
3	$ 27,426	$ 23,422	$ 4,004	$ 3,992,027	$ 3,996,031
Sum	N/A	N/A	$ 7,973	$ 3,992,027	$ 4,000,000
NPV	N/A	N/A	$ 7,118	$ 3,448,463	$ 3,455,582

Upon the surrender of a contract at the end of year 3, the policyholder reports as taxable income the difference between the cash value of the policy at that time ($27,426) and its adjusted basis of $23,422, or $4,004. Multiplying this amount by 997 (the number of policyholders assumed to surrender their policies at the end of year 3) yields total income from cash surrender benefits of $3,992,027, as shown in column (4) of Table 5A.

Current law's statutory exclusion for death benefits is removed in the modified normal tax baseline. Nevertheless, under the "basis-first" rule for distributions, the portion of death benefits paid from mortality charges, $973,312 in year 1, is distributed tax-free to policyholders as a return of capital. The policyholder with a deceased insured has an adjusted basis of $25,371 in year 1. The receipt by the policyholder of this amount is also treated as a return of capital. The remaining amount (the excess of the "deceased" contract's reserve value over its adjusted basis) represents accumulated earnings that have been credited (tax-free from the policyholder's perspective) to that contract.[21] In

[20] This approach is reflected in Rev. Rul. 2009-13, in which the IRS has ruled that the adjusted basis for measuring income received from a sale of a contract (as opposed to measuring income received from a distribution of cash from a contract) is determined after subtracting the contract's cost of insurance protection. In the current example, that cost of protection equals the mortality charges assessed against the policy's reserve. For simplicity, we adopt a "basis-first" rule with respect to mortality charges. If a mortality charge exceeds the contract's basis, then that basis is reduced to zero, and the excess of the mortality charge over basis is treated as taxable income of the policyholder. Unlike under current law, the use of a basis-first rule does not lead to a deferral of income under the modified normal tax baseline.

[21] With a variable contract, it is possible that the contract's basis could exceed the value of its life insurance reserve. In this case, unlike under current law, a loss could be recognized by the owner of the contract.

the example, this taxable portion of the death benefit amounts to $1,317 in year 1, $2,652 in year 2, and $4,004 in year 3. These amounts, shown in column (3) of Table 5A, are added to taxable income on the income tax return of the policyholder with the deceased insured. Finally, as mentioned, the $1,000,000 death benefit transferred annually to a beneficiary by the life insurance company on behalf of policyholders is treated as a tax-free gift from policyholders to the beneficiary.

Taxable death benefits and taxable cash surrender benefits are combined and reported in column (5) of Table 5A. When summed over time, they total $4,000,000, which is the amount of interest earned on the insurance contracts over the three-year period. However, the recognition of these amounts is deferred when compared with the taxable amounts under the economic income baseline, as can be seen by comparing the final column of Table 5A with column (5) of Table 4.

This deferral problem is addressed when we consider the treatment of the life insurance company under the modified normal tax baseline. Unlike under current law, the life insurance company is allowed the same accounting treatment as other corporations. Under Generally Accepted Accounting Principles (GAAP) and under current tax law rules, noninsurance corporations cannot reserve for future contingent events that have not yet occurred (such as future premium receipts and benefit payments). Nevertheless, corporations may establish "prepaid income" liabilities that reflect amounts received in advance of their accrual as income. This treatment reflects the GAAP principle whereby receipts are matched, without an interest discount or interest premium, to the accounting period or periods in which events occur that establish a claim of the company to the income. In the current example, these rules imply that the insurance company may establish an "unearned premium reserve," but changes to this reserve are limited to the addition of premium payments and the subtraction of untaxed distributions (consisting of untaxed mortality charges and untaxed death and cash surrender benefits).[22] The company is allowed a tax deduction for an increase in its aggregate unearned premium reserve, and includes in gross income any decrease in that reserve.[23]

The company results are exhibited in Table 5B. At the end of year 1, the aggregate unearned premium liability equals $25,345,489, which is also the aggregate investment basis of the surviving policyholders.[24] As shown in column (1) of the table, this liability decreases to $24,348,140 by the end of year 2, and to zero by the end of year 3, when all policyholders have surrendered their contracts.[25] In year 1, the company includes premium receipts of $26,344,171 and interest earnings of $1,317,209 in gross income, but is able to take a deduction of $1,000,000 for amounts distributed

[22] The reference to "untaxed" portions of contract distributions refers to the portions that are treated as a return of capital to policyholders. Thus, they represent portions of the original premium that have been returned to policyholders.
[23] The company continues to maintain life insurance reserves for the purpose of accounting for future premiums and benefits. However, under the modified normal tax law baseline, these reserves are ignored for the purposes of computing taxable income.
[24] The value of the company's aggregate unearned premium reserve at the end of year 1 reflects the receipt of $26,344,171 in premiums, the withdrawal of $973,312 in aggregate mortality charges, and a reduction of $25,371, the amount of the unearned premium reserve attributable to the policy insuring the individual who died in year 1. After accounting for rounding error, this reserve value equals $25,371 (a single contract's adjusted basis at the end of year 1), multiplied by 999 (the number of surviving policies at the end of year 1).
[25] The reduction in the unearned premium reserve in year 2 is the result of the withdrawal of $972,951 in aggregate mortality charges, and a subtraction of $24,397, the amount of the unearned premium reserve attributable to the policy insuring the individual who died in year 2. After accounting for rounding error, the aggregate reserve value equals $24,397 (a single contract's adjusted basis at the end of year 2), multiplied by 998 (the number of surviving policies at the end of year 2).

to pay death benefits and a deduction for the $25,345,489 increase in its unearned premium reserve. The net company taxable income is $1,315,891, as shown in column (4) of the table. This amount equals the investment income earned by the company and credited in that year to its remaining life insurance reserves. The company's taxable income does not include the $1,317 of interest income earned on company assets and credited to the life insurance reserve of the policy having a deceased insured. As described above, that income is taxed to the relevant policyholder upon distribution of assets underlying the reserve, as part of the payment of a death benefit. Similarly, in year 2, the company's gross income consists of $1,333,069 in investment income, plus $997,348, the amount by which its unearned premium reserve has declined. A deduction of $1,000,000 for the death benefits payment is allowed. Again, the resulting taxable income for year 2, shown in column (4), equals the change in the amount of the annual inside buildup not yet taxed to policyholders.

TABLE 5B

Income Under the Modified Normal Tax Baseline

	Insurance Company				All Taxpayers
	(1)	(2)	(3)	(4)	(5)
Year	Unearned Premium Reserve	Current Cash Flows (Premiums + Interest – Benefits)	Change in Premium Reserve	Taxable income	Total Taxable income
	EoY	EoY	EoY	EoY	EoY
1	$ 25,345,489	$ 26,661,380	$ 25,345,489	$ 1,315,891	$ 1,317,209
2	$ 24,348,140	$ 333,069	$ (997,348)	$ 1,330,417	$ 1,333,069
3	$ -	$ (26,994,449)	$ (24,348,140)	$ (2,646,309)	$ 1,349,722
Sum	N/A	$ -	$ -	$ -	$ 4,000,000
NPV	N/A	$ 2,375,074	$ 2,201,097	$ 173,977	$ 3,629,558

In year 3, the company has interest income equal to $1,349,722, plus income of $24,348,140 due to the elimination of the unearned premium reserve. It takes a $1,000,000 death benefit deduction and a deduction for cash surrender benefits of $27,344,171, yielding a company taxable loss of $2,646,309. This net loss may be thought of as having two components. The first is an increase in income of $1,345,718, the amount of inside buildup taxable to the company prior to the distribution of the cash surrender benefits. The second is a deduction for $3,992,027, which is the total inside buildup attributable to these policies over the three-year period prior to its distribution and which was treated as company taxable income.[26] As can be seen from column (4) of Table 5A, this second component is the same amount of income taxed to policyholders as gain from the receipt of their cash surrender values. Thus, in terms of taxable income, the company's loss from its payment of surrender benefits is exactly offset by the gain recognized on that distribution by policyholders. This

[26] The total investment income of the company is $4,000,000. The difference between this amount and the loss specified in the text is the $7,973 of income that was taxed to policyholders with deceased insureds when they received the cash equivalent of their contract reserves. See column (3) of Table 5A.

result also implies that the sum of the company's taxable incomes over the three-year period is zero, as shown in column (4) of Table 5B.

Summing the taxable incomes of the policyholders and the company in each year yields an annual total taxable income that equals the investment income earned on the company assets in that year. Compare the final column of Table 5B with column (5) of Table 2 and column (5) of Table 4. The total taxable income under the modified normal tax law baseline is the same as that determined under the economic income tax baseline. Thus, all interest income is reported as it accrues. Also, as under the economic income tax baseline, all interest income is ultimately attributed to policyholders. The difference is that, under the economic income tax baseline, all interest income is taxed to policyholders as it accrues (although a portion of this tax liability is shifted to beneficiaries as a result of the transfer of death benefits). Under the modified normal tax law baseline, as the investment income accrues, a portion is taxed to policyholders as gain recognized on the distributions of reserves used to help fund the payment of death benefits, and a portion is taxed to the company. However, when cash is distributed (whether as cash surrender benefits or as death benefits), a deduction for previously taxed insurance company income is allowed (as part of the company's deduction for benefits paid), but the same amount of income is taxed to policyholders on the receipt of that cash. These deductions and inclusions are offsetting, so that the timing of the recognition of inside buildup as taxable income is unchanged. If all taxpayers had the same marginal tax rates, the tax expenditure estimate under the modified normal tax law baseline would be equivalent to that found under the economic income tax baseline. When those marginal tax rates differ, however, the tax expenditure amounts measured using the different baselines would diverge.

Conclusion

We conclude by summarizing our findings. First, we recognize that the Budget Act requires the identification of "provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income" in order to define a tax expenditure. The meaning of the term "provisions of Federal tax laws," however, is unclear. It is debatable, for example, that a provision must explicitly grant an exclusion from gross income. An alternative interpretation might be that there exist specific legal provisions that together produce an exclusion of income. Furthermore, the Budget Act does not specify what constitutes the correct tax baseline against which to measure tax expenditures. While the concept of economic income motivates the construction of such a baseline, there can be legitimate arguments for deviating from that standard for the purpose of identifying and measuring tax expenditures.

Both the JCT and the Treasury define their tax expenditure baselines on a modified version of an economic income tax baseline. We have shown in this note that the treatment of life insurance inside buildup under the current tax law is indeed a tax expenditure when measured against an economic income tax baseline, because current law income recognition accounting rules fail to account for future benefits to be received by policyholders. Furthermore, even if we maintain these income recognition rules as part of a modified "normal" tax baseline, we are able to identify certain IRC provisions that result in a tax expenditure for life insurance inside buildup. When these provisions are removed, creating our modified normal tax baseline, the aggregate taxable income patterns produced by life insurance inside buildup are equivalent to those under the economic income tax baseline.

When using either baseline, it is clear that a substantial portion of investment income earned within life insurance contracts is not taxed under current law. In fact, the tax expenditure for inside buildup is the 15th largest tax expenditure in the President's Budget, with an estimated cost of $370 billion over the 2016-2025 period.[27] While aggregate taxable income is equivalent under the two baselines, the allocation of taxable income between policyholders and life insurance companies varies substantially, depending on the baseline used. Similarly, proposals to eliminate this tax expenditure could allocate the income to either individuals, insurance companies, or some combination of the two.

The economic income tax baseline suggests inside buildup represents income for policyholders. For example, in 1984 the Treasury proposed to tax part of the inside buildup, by taxing owners of cash value life insurance policies on the increase in the amount that a policy's cash surrender value exceeds the contract's basis, where the latter is reduced by the annual mortality cost of insurance.[28] This proposal was not adopted, and more recent reform proposals have not focused on taxing inside buildup. Taxing individuals on an accrual basis may prove difficult in practice. First, policyholders could face substantial cash flow problems if they are taxed on income that they cannot readily access (Gravelle and Hungerford, 2012).[29] Johnson, Pike and Lustig (2009)[30] suggest that these cash flow concerns can be mitigated by creating information reporting and withholding requirements for life insurance companies. Under this policy, insurance companies would withhold tax on inside buildup[31], and provide information to policyholders on both the amount of inside buildup and tax withheld. Still, taxing policyholders would continue to require complex accounting methods to allocate inside buildup between the company and policyholders, and further allocate inside buildup among specific policyholders (Neubig and Steuerle, 1984).[32]

One alternative is to treat inside buildup as taxable income for the insurance company. Rather than withholding tax on inside buildup, and providing an information return to policyholders, the insurer could be directly taxed on inside buildup.[33] One benefit of this policy would be administrability. Any distributions to policyholders or beneficiaries would be after tax, eliminating the need to allocate investment income to individual policyholders, or to track investment basis. However, compared to Johnson, et al.'s (2009) proposal, such a policy would raise the same distributional concerns that apply to other income subject to corporate-level taxes, in that it applies a single tax rate to all inside buildup income, regardless of the marginal tax rates faced by individual policyholders (Neubig and Steuerle, 1984).

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[27] Again, this estimate includes the deferral of tax on earnings of annuity contracts, in addition to life insurance contracts. *Analytical Perspectives* (2016), Table 14-3.

[28] Department of the Treasury (November 1984) *Tax Reform for Fairness, Simplicity, and Economic Growth*, Volume 2, General Explanations of the Treasury Department Proposals, pp. 258-261.

[29] Jane G. Gravelle and Thomas L. Hungerford (March 22, 2012) "The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening," Congressional Research Service, R42435.

[30] Calvin Johnson, Andrew Pike, and Eric A. Lustig (February 2009) "Tax on Insurance Buildup," http://tax.network/cjohnson/tax-insurance-buildup/ previously published by the University of Texas School of Law.

[31] Johnson, et al. (2009) define earnings from an insurance contract, or inside buildup, as the increase in the cash surrender value of the policy, plus the cost of insurance, net of premiums paid.

[32] Thomas Neubig and Eugene Steuerle (January 1984) "The Taxation of Income Flowing Through Life Insurance Companies" Office of Tax Analysis, OTA Paper 53.

[33] One option is to measure inside buildup using Johnson, et al.'s (2009) definition of "earnings from an insurance contract." However, an alternative definition would be required for term life insurance policies.