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KEEP INTEREST DEDUCTIBLE ON LOANS BACKED BY CORPORATE OWNED LIFE INSURANCE

The tax bill developed by the House Ways and Means Committee has a provision that would deny the normal interest-expense deduction for interest costs businesses incur when they borrow against their corporate owned life insurance policies (COLI policies). This disallowance would apply to all interest payments made after 1995 on loans secured by COLI policies, including interest payments on already outstanding loans. The Senate Finance Committee's version of the bill would also terminate the interest deduction on these borrowings, with the exceptions that the interest deduction would continue on loans existing prior to June 20, 1986, and would be phased out over five years on loans existing prior to 1996.

The COLI proposal is rank expediency, a violation of sound tax principles. The House-Senate Conference Committee on the reconciliation bill should drop the COLI proposal.

As an example, suppose a business borrows against a COLI policy and subsequently makes a $1,000 interest payment on the loan it has obtained. Under current law, the company can deduct this interest payment from its taxable income. Under the House and Senate plans, it could not. (If the loan existed prior to 1996 and the interest was paid in the period 1996-2000, the Senate Finance Committee's version would allow a partial deduction.) At a 35 percent corporate tax rate, the denial of the deduction would raise the company's tax bill and, thus, increase its cost of doing business by $350.

Although the U.S. Treasury Department has long viewed denial of the interest-deduction on COLI-backed loans as a possible revenue raiser, preventing a business from claiming an interest expense violates fundamental tax principles. First, it taxes businesses on income they do not have. Income is revenues less expenses, and interest costs are business expenses. Second, because the lender must include the interest in its own taxable income, the denial of the interest deduction produces double taxation: the government is taxing both the lender and the borrower on the same income. (Lenders on COLI policies are generally insurance companies, and although their tax treatment is extremely complex, they do pay tax.) Somehow, government officials who are so concerned whenever they feel the government is not collecting all it should have no compunction about taxing two different taxpayers on the same income.

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Those who object to the interest deduction seem to think that paying interest is costless. In fact, interest payments reduce the resources of the payers, which is why people don't borrow unless the use of the borrowed funds produces revenues greater than the cost of servicing the debt. In the real world, of course, households and business borrow for purposes like buying homes,

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financing equipment purchases, financing inventory, etc. Case studies reveal that companies generally borrow against COLI policies to finance employee benefits, with an emphasis on health and retiree benefits. Paying interest on a loan backed by a COLI policy is just as much a real expense as, for example, making monthly interest payments on a home mortgage.

> ***[T]he provisions are retroactive in the sense that they would change the tax treatment of outstanding COLI policy loans in midstream... Retroactive taxation ... weakens saving and investment [and] raises a basic issue of fairness... Households and businesses holding other types of insurance policies should be concerned about the precedent set here.***

Advocates of repealing the interest deduction claim such action is justified because the collateral (COLI policies) enjoys favorable tax treatment. COLI policies often take the form of cash value life insurance. Some part of the premiums paid for the policies is invested by the insurer, generating interest and other income the cumulative amount of which provides the policies' cash value. These policy earnings, the so-called "inside buildup," are tax deferred, subject to tax when the insurance proceeds are distributed. This tax deferral is a modest step in the direction of moderating the income tax bias that results from taxing both income that is saved and the income produced by investing those savings. It should be reinforced by providing similar treatment of other forms of saving, not offset by denying the deduction for interest on borrowing to purchase such policies.

> ***In 1993, many of the members of Congress now in the majority were well aware of the demerits of retroactive taxation and vigorously opposed, as a matter of principle, the retroactive tax rate increases contained in the 1993 budget bill.***

Furthermore, if the argument of the provision's supporters were followed consistently, it would quickly lead to a profound upheaval in the tax treatment of many types of loans. Suppose, for example, that the owner of a small business needs a loan and uses as collateral commercial real estate in a developing area. Much of the property's value probably consists of appreciation, and tax on that appreciation is deferred until the person sells the property. Should the tax treatment of this collateral, specifically, deferring income tax on the increase in the property's value, be grounds for the government to deny the small business owner a tax deduction for the interest expense on any mortgage on the property? That is the troubling conclusion one would draw from the argument for denying an interest deduction on COLI backed borrowings.

In an effort to collect more revenue faster, the provisions are retroactive in the sense that they would change the tax treatment of outstanding COLI policy loans in midstream. This is a worrisome precedent in that it would violate the long-standing principle of altering the tax treatment of insurance only prospectively, affecting future policyholders but not holders of outstanding policies. Retroactive taxation of any sort raises a basic issue of fairness: after taxpayers have made commitments under one set of tax rules, the government later, in effect, says "Gotcha" and taxes those actions under different, harsher rules. Households and businesses holding other types of insurance policies should be concerned about the precedent set here.

In addition, retroactive taxation weakens saving and investment. When people become fearful about punishing tax surprises, the after-tax income they expect to receive as a reward for saving and investing becomes less secure. That government-created risk lessens people's incentives to save and invest. Thus, retroactive taxation adds to the numerous biases the U.S. tax system already imposes on saving and investment. In 1993, many of the members of

Congress now in the majority were well aware of the demerits of retroactive taxation and vigorously opposed, as a matter of principle, the retroactive tax rate increases contained in the 1993 budget bill.

The proposal to deny an interest deduction on borrowings backed by COLI policies does have the political appeal of collecting a substantial amount of revenue while being hidden from most voters. The Joint Committee on Taxation estimates the Senate Finance Committee version would gather $6.4 billion over the period 1996-2002; the House version with its more abrupt retroactivity would collect more. Despite its political allure, however, hidden taxation is very bad public policy. It conceals the true costs of what must be paid for government services, which leads people to underestimate what they must actually pay for government programs and to demand too great a quantity of government services.

The leadership in both the House and Senate have promised the nation a government based on sound principles for a free society. The COLI proposal is rank expediency, a violation of sound tax principles. The House-Senate Conference Committee on the reconciliation bill should drop the COLI proposal.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.