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Tax Treatment Of Inside Buildup In Life Insurance Products

By Michael A. Schuyler

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EXECUTIVE SUMMARY

Under current law, holders of cash value life insurance policies generally buy their policies with after-tax dollars and do not pay further taxes while the policies remain in force. Death benefits are generally tax exempt. Policyholders, however, are taxed on the net returns if they redeem the policies prior to death. In most cases annuity holders also buy their policies with after-tax dollars. They usually do not pay further taxes until annuity distributions begin. After distributions commence, however, the net returns are taxable. Annuity holders are also taxed on loans backed by their annuities.

This tax treatment is similar, but somewhat harsher, than what would be required under a tax that is assessed on the amount saved but not the returns to that saving. Such a tax can be described as a pre-paid consumption-based income tax. By taxing the saving stream exactly once, a consumption-based income tax preserves tax neutrality between saving and immediate consumption. Because of the contributions that saving makes to economic progress, a consumption-based income tax's lack of an anti-saving bias is extremely valuable. This treatment is also fairer to savers than a levy that taxes the saving stream at multiple points, and it is simpler.

Government reports from the General Accounting Office (GAO) and the U.S. Department Of The Treasury have criticized the tax deferral on inside buildup. Inside buildup is the name given to returns on saving that are held within the policies and not yet distributed to policyholders. Both reports urge Congress to reconsider the deferral and, if the deferral is not eliminated, contain recommendations for restricting the deferral. For example, both reports advocate taxing loans that are backed by life insurance or annuity policies, and the Treasury Report would arbitrarily redefine annuities for tax purposes so that most inside buildup in annuities would be immediately taxable to policyholders. If the recommendations were followed, they would increase taxes for millions of life insurance and annuity policyholders. Policy ownership would drop substantially. In the extreme case in which policyholders were taxed on a current basis on inside buildup, the tax bias against holding cash value life insurance policies or most annuities would have a devastating impact on policy ownership. Even if those financial instruments still survived, most people would try to avoid them for tax reasons. In the spring of 1994, the Administration seriously considered a proposal, ultimately rejected by the White House, to finance higher welfare spending by limiting the amount of inside buildup in an annuity holder's policy that would be eligible for tax deferral.

The government reports take as their ideal a particular definition of income known as the accretion or Haig-Simons concept of income. This definition of income calls for taxing both saving and returns on that saving. By directing that the saving stream be taxed repeatedly, a Haig-Simons income tax generates a bias against saving and investment. The government reports, however, fail to recognize that multiple taxation of the saving stream penalizes saving relative to immediate consumption. Such multiple taxation would be a large step in the wrong direction. It would be complicated, unfair to policyholders, cause some of them liquidity problems, and, most important, diminish the volume of saving and investment by worsening the tax system's overall bias against saving.

The government's "tax expenditures" budget, which purports to be a listing of special tax breaks bestowed on taxpayers, categorizes the current tax treatment of life insurance products as a "tax expenditure". The reason for that, however, is that the government's standard of comparison, what it assumes to be the "normal tax structure", envisions taxing the saving stream repeatedly. Measured against a tax baseline not biased against saving, however, the tax treatment of life insurance product policyholders generates no "tax expenditure". In fact, life insurance products are slightly overtaxed because of the tax imposed on cash value policy redemptions and annuity distributions. If a "tax expenditures" budget continues to be produced, the reference tax system should be a consumption-based income tax.

The current tax treatment of life insurance products generally accords with sound tax principles. If the government changed the rules to begin taxing inside buildup and perhaps a portion of death benefits, the results would be less efficiency, less equity, and more complexity. Positive reform of the tax treatment of life insurance and annuity policyholders does not call for added taxes. The proper reform would be to discontinue the taxation of all distributions, provided the initial amounts saved have been taxed.

Tax Treatment Of Inside Buildup In Life Insurance Products

Introduction

In early 1990, the U.S. General Accounting Office (GAO) and the U.S. Department Of The Treasury issued separate reports that criticized the federal income tax treatment of those who own cash value life insurance policies or annuity contracts.[1] According to the reports, the government should more aggressively impute income to policyholders and then force policyholders to pay tax on such imputed income immediately. The reports had been ordered by Congress as part of the Technical And Miscellaneous Revenue Act Of 1988. Another government agency, the Office Of Management And Budget (OMB), has also faulted the tax treatment of life insurance and annuity policyholders. Each year, OMB prepares a "tax expenditures" budget, which purports to identify special breaks from normal income tax rules and to estimate the cost of those breaks to the government. OMB includes the tax treatment of life insurance policyholders in its "tax expenditures" listing and claims that the alleged subsidy amounts to $8.1 billion in 1994.[2]

The target of the reports is what is known as inside buildup — the unrealized investment returns that normally build up within cash value life insurance policies and annuities before policyholders begin receiving benefits. In most cases policyholders are not required to include these

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[1] U.S. General Accounting Office, *Tax Treatment Of Life Insurance And Annuity Accrued Interest*, GAO/GGD-90-31, January 29, 1990; and U.S. Department Of The Treasury, *Report To The Congress On The Taxation Of Life Insurance Company Products*, March 1990.

[2] Office Of Management And Budget, *Budget Of The United States Government, Analytical Perspectives, Fiscal Year 1995* (Washington, DC: Government Printing Office, January 1994), pp. 53-78.

unrealized returns in their current incomes, which means that policyholders usually are not taxed on the returns before they receive them. Both reports view this tax deferral very skeptically. Although neither comes right out and says the deferral should be eliminated, the GAO Report and more so the Treasury Report would tighten the rules, with the result that substantially fewer policyholders would qualify for the deferral.

The premiums on a life insurance policy must be adequate to cover death benefits (mortality risk). They must also compensate insurance carriers for administrative expenses and provide the carriers with a competitive rate of return (together called loading charges). Life insurance that is priced just to meet mortality risk and loading charges is known as term life insurance. Two characteristics of term life insurance are that premiums rise over time because of increasing mortality risk and that a term life policy has no value beyond what it pays if the insured dies during the term of the policy. Alternatively, premiums can be set higher, at least in the early years of the policy, to provide a saving component. This saving component and the investment return it earns can be used in later years to help pay premiums and to provide a cash payout to policyholders who choose to redeem their policies during their lifetimes. Policies with this saving component are called cash value life insurance policies.[3]

The negative findings in the GAO and Treasury Reports follow entirely from a flawed central assumption regarding the proper standard against which to judge sound tax policy. Correcting the error reveals that the current federal income tax treatment of policyholders is moderately close to what it should be. Contrary to the two reports, policyholders are not undertaxed; indeed, in many instances they are overtaxed. If the tax treatment of life insurance products were changed to conform with the reports' recommendations, the results would be unfair to policyholders, would add to the tax system's

[3] Cash value life insurance policies can be further divided depending on various characteristics of the policies. The most traditional form is whole life insurance. Two of the other types are universal life insurance and variable life insurance. All types provide a saving component.

complexity, and would worsen economic inefficiencies by intensifying the tax system's bias against saving and investment.

The same erroneous central assumption is also responsible for the presence of life insurance products in the "tax expenditures" budget. When a sounder benchmark is used, the current treatment of life insurance is seen to involve no "tax expenditures". Moreover, the concept of "tax expenditures" has other serious deficiencies that counsel against its being used as a policy tool.[4]

The central analytical issue concerns the proper tax treatment of saving and returns on saving. The GAO and Treasury Reports rely on what is known as the accretion or Haig-Simons definition of income, which calls for including both saving and returns on that saving in the tax base. This taxation of both income that is saved and, later, the income that the saving produces results in a bias against saving. The resulting bias pushes people toward greater consumption uses of current income. The "tax expenditures" budget employs a "reference" tax base that, while it does not conform closely to any theoretically pure definition of income, leans toward the Haig-Simons concept. In the case of life insurance products, OMB includes both saving and returns on that saving in its "reference" tax base.

An alternative income concept designates income used for consumption as the appropriate tax base. This definition of income calls for taxing either the amount that is saved or the returns on that saving — but not both. An income tax relying on this concept of income might be called a consumption-based income tax. Whereas a Haig-Simons income tax is biased against

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[4] See Norman B. Ture, *Tax Expenditures: A Critical Appraisal*, a report to the Savers And Investors Foundation (Washington, DC: Institute For Research On The Economics Of Taxation), 1990.

saving and investment, the key virtue of a consumption-based income tax is that it does not create an anti-saving bias.[5]

The examination of life insurance products highlights a very important area of tax policy: the appropriate income tax treatment of saving. The low level of saving in the United States has focused attention on the existing tax system as a contributing cause. There is a growing recognition of the income tax bias against saving. An income tax based on an alternative income concept that is neutral between saving and immediate consumption would eliminate the anti-saving bias in the income tax and would put consumption and saving uses of income on a more nearly equal tax footing. The recommendations of the GAO and Treasury Reports (and the conclusion one might draw from OMB's "tax expenditures" budget) would move the tax system in the opposite direction, intensifying the anti-saving bias and exerting further downward pressure on the saving rate.

The results of the present analysis can be applied, of course, to many forms of saving, not just insurance products.

A study by C. David Anderson evaluates the tax treatment of life insurance and annuity policyholders in light of government criticisms.[6]

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[5] For several more detailed comparisons of Haig-Simons income and consumed income as bases for an income tax, see: David F. Bradford, *Blueprints For Basic Tax Reform*, Second Edition, Revised (Arlington, VA: Tax Analysts, 1984); Michael A. Schuyler, *Consumption Taxes: Promises & Problems*, Foreword by Norman B. Ture (Washington, DC: Institute For Research On The Economics Of Taxation, 1984); and Norman B. Ture and Stephen J. Entin, *Save, America: A Primer On U.S. Saving And Its Effect On Economic Health* (Washington, DC: Institute For Research On The Economics Of Taxation, 1989).

[6] C. David Anderson, "Conventional Tax Theory And `Tax Expenditures': A Critical Analysis Of The Life Insurance Example," *Tax Notes*, December 7, 1992. The *Tax Notes* article is a condensed version of an earlier paper with the same name: C. David Anderson, "Conventional Tax Theory And 'Tax Expenditures': A Critical Analysis Of The Life Insurance Example," June 1991 Draft (February 4, 1992 print).

Anderson's conclusions are similar to those derived here. Anderson began by observing that income used for consumption is a more desirable tax base than Haig-Simons income. He then argued that the "tax expenditures" budget should be recomputed, with income used for consumption substituted for Haig-Simons income as the baseline against which to measure deviations. Once the substitution is made, the taxation of life insurance products entails no "tax expenditure". Anderson next argued that if no "tax expenditure" is present, the main support for the conclusions of the GAO and Treasury Reports falls away, revealing that their conclusions are erroneous. Anderson devoted much of his paper to developing several fallback defenses of the current tax treatment of life insurance products: many other types of saving have similar tax treatment; because of various extenuating circumstances, the tax treatment of life insurance products is not a "tax expenditure" even when measured against the Haig-Simons baseline; and various social benefits of life insurance products would justify current law even if it did entail a "tax expenditure".

The present study differs from Anderson's in centering the analysis on the appropriate tax base, not the "tax expenditures" budget. Once the proper tax base is identified, the findings and conclusions of the GAO and Treasury Reports collapse, even before addressing the "tax expenditures" concept. In addition, this study examines flaws in the "tax expenditures" concept not noted in the Anderson paper that are further warnings against using the "tax expenditures" budget as a policy tool. This study also considers Anderson's fallback positions, which he heavily emphasizes, but judges that they should receive much less attention than the main argument.

Although Treasury Secretary Lloyd Bentsen has stated that he opposes the taxation of inside buildup, OMB floated a proposal in early 1994 (as part of an effort to finance a more expensive, "reformed" welfare system) that would have restricted the tax deferral on inside buildup in annuities.[7] The

[7] Treasury Secretary Bentsen's comments were reported in *Daily Tax Report*, November 16, 1993, G-5. For an analysis of the proposed tax on annuity policyholders, see Michael A. Schuyler, "Kill The New Tax On Annuities," *The Journal Of*

proposed annuity tax went all the way to the President before being rejected. While that particular hostile tax change directed at policyholders was eventually dropped, revenue-raising proposals tend to resurface in Washington; they are rarely forgotten. A revenue-raising proposal is particularly likely to return when two government reports and OMB's "tax expenditures" budget can be trotted out on its behalf. The Clinton Administration will be strongly tempted to seek additional tax sources in the future because of the vast cost of its long agenda of new and expanded spending programs.

In the face of such pressures, opposition to taxing policyholders on inside buildup should be based on a clear understanding of why the deferral of tax on inside buildup should be retained, as under present law. Unfortunately, those who defend present law often describe it as a tax break, but then try to defend it as a justifiable tax break. This portrays tax deferral as a special favor that the government magnanimously extends to policyholders for their own good and to bolster the nation's saving rate. Compared to a tax system that is evenhanded between saving and consumption, however, the deferral is not an incentive at all; it is merely neutral tax treatment. If the deferral were ended, the altered taxation of policyholders would be a powerful saving *dis*incentive, a tax tilt against using life insurance and annuities for insurance purposes and as saving vehicles.

Current Tax Treatment Of Policyholders

Holders of cash value life insurance policies generally purchase the policies with after-tax dollars. They normally do not pay tax on the investment return, which is known as inside buildup, as long as the return remains in the policy. Instead, while investment returns stay in the policy, the policyholder's tax is deferred. If the policyholder redeems the policy for cash, the amount by which the cash payment exceeds the premiums is then

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Commerce, May 13, 1994, 6A and Ron Suskind, "Clinton Sends Budget Officials Back For New Ways To Fund Welfare Reform," *The Wall Street Journal*, May 25, 1994, A2.

considered taxable income and the policyholder must pay tax on it. If the policyholder dies while the policy is still in force, however, the inside buildup is not subsequently taxed because death benefits are tax exempt.

In 1984, saying it was "concerned with the proliferation of investment-oriented life insurance products", Congress defined statutory tests that products had to meet in order to qualify for tax treatment as life insurance.[8] Congress narrowed the definition of what qualified as life insurance for tax purposes in 1988 in response to the rising popularity of single premium life insurance policies.[9]

In general, holders of annuity policies also make their purchases with dollars that have already been subject to tax. Under long-standing law and practice, tax is deferred on the investment returns generated by the funds within the policies. Distributions in excess of premiums, however, are regarded as taxable income. (The tax provisions are complicated and provide somewhat arbitrary rules for apportioning distributions between income and the return of principal.)

Unlike life insurance policyholders and most other asset owners, annuity owners are taxed on loans backed by their policies and, beyond that, are often

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[8] Senate Committee Report to the Tax Reform Act of 1984, reprinted in Commerce Clearing House, *Federal Tax Guide Reports*, Vol. 67, No. 42, CCH Special 5, July 20, 1984.

[9] As the name implies, single premium life insurance policies are purchased with a single up-front premium. Because all of the payment except the portion needed to cover initial period expenses remains within the policy, this arrangement tends to produce a large saving element. The restrictions also affected some policies with a large share of the premiums paid in the first few years of the policy's life. For additional information see the Conference Report to the Technical And Miscellaneous Revenue Act Of 1988, reprinted in Commerce Clearing House, *Federal Tax Guide Reports*, Vol. 72, No. 4, CCH Special 6, October 24, 1988, pp. 127-142.

assessed a 10 percent penalty tax on the loans. This tax treatment dates from the Tax Equity And Fiscal Responsibility Act Of 1982 (TEFRA).[10]

Tax Treatment Of Life Insurance Products Compared To Two Tax Base Concepts

A tax base often mentioned in theoretical discussions is the accretion or Haig-Simons' concept of personal income. This is an extremely broad tax base that is intended to include all personal gains during a period of time. On the assumption that gains must either be consumed or accumulated, Simons wrote, "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."[11] It was not proposed that people actually report consumption and wealth accumulation directly on their tax forms but rather that they be taxed on a very broad measure of their gains. The Haig-Simons tax base would encompass wage income, the majority of fringe benefits (including most that are now tax free or tax deferred), interest and dividends (including those that are now tax exempt), realized capital gains (and probably unrealized gains, as well), virtually all other returns on saving, receipts of gifts and bequests, perhaps some in-kind income from one's services for oneself (e.g., home repairs, housework), and some imputed income from the services of one's consumer durables (e.g., the rental income homeowners would derive if they rented their homes to themselves).

The treatment of life insurance products obviously does not conform with this tax base. One difference is that death benefits are tax exempt. Another

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[10] The tax is based on two arbitrary assumptions: first, that the loans are actually distributions from the annuities, and, second, that the distributions come entirely from investment returns until the returns have been exhausted and, only then, from the principal. (Distributions from principal, i.e., recovery of basis, would not be taxable.)

[11] Henry C. Simons, *Personal Income Taxation* (Chicago, IL: The University Of Chicago Press, 1938), p. 54.

difference is that life insurance and annuity policyholders are not taxed on unrealized returns from inside buildup. Both of these elements of the current tax treatment of life insurance are at odds with the Haig-Simons definition of income.

Another tax base frequently considered in theoretical analyses is income used for consumption. This tax base is most frequently constructed as a taxpayer's cash flow less business expenses minus the taxpayer's net saving. For example, if a taxpayer has wage income of $30,000, interest and dividends of $6,000, saves $3,000 during the year, and borrows $2,000 during the year (implying net saving of $1,000), the person's tax base is $35,000 ($30,000 + $6,000 - $1,000). What this amounts to with regard to saving and returns on saving is that the tax is deferred: funds are not taxed while they are saved but they are fully taxed (including both principal and returns) upon withdrawal.

For instance, if a person saves $1,000 this year and earns a 10 percent return on it which is also saved, none of the $1,100 is included in this year's tax base. But if the funds are withdrawn next year for consumption, the entire $1,100 is added to the person's second-year tax base. If the tax rate is, say, 30 percent, the first-year tax on the saving and on the returns to saving is zero; the second-year tax on the $1,100 gross distribution is $330, which leaves the person with $770 after tax. (If the person had, instead, used the $1,000 for immediate consumption, it would have been taxed in the first year. At a 30 percent tax rate, the tax on the $1,000 would have been $300, leaving $700 of after-tax income available for first-year consumption.) Tax-deductible individual retirement accounts (IRAs) operate in approximately this manner, although on a limited scale.

Another version of a consumption-based income tax is to tax saving but not the returns to saving. This is sometimes called a pre-paid consumption-based income tax. Its results are generally algebraically equivalent to the other version. With a pre-paid consumption-based income tax, the person in the previous example would pay tax in the current year on the $1,000, save the $700 of after-tax income that remains, and have a return on that saving of $70. Neither the $700 of after-tax saving nor the $70 return would be subject to further tax. Thus, the person's gross after-tax return would be $770, as it was in the other version of the consumption-based income tax. (It is assumed that the tax rate continues to be 30 percent and the rate of return 10 percent.)[12]

The tax treatment of life insurance products has similarities to the pre-paid version of a consumption-based income tax. Policyholders purchase life insurance and annuity policies with after-tax dollars. Thereafter, they generally pay no tax on returns to the amounts invested in the policies while the policies remain in force. This mirrors a pre-paid consumption-based income tax, which includes the initial saving in the tax base but does not tax the returns to that saving. The present exemption for life insurance policies' death benefits also accords with a pre-paid consumption-based income tax. Current law falls short of a pre-paid consumption-based income tax, however, with respect to non-death benefits. When annuities begin making payouts, policyholders must pay tax on the net returns. Likewise, if holders of cash value life insurance redeem the policies prior to death, as many do, they are subject to tax on the net returns. Under a pre-paid consumption-based income tax, policyholders would not be taxed on any of these benefits.

Income Used For Consumption Is A Better Tax Base Than Haig-Simons Income

The main problem with virtually all taxes is that they distort the apparent costs and benefits of various activities, causing people to make wasteful production and consumption decisions that are a drag on the economy. When a tax raises the apparent cost or lowers the apparent benefit of an activity, some people decide to forgo it for pursuits that are less desirable on a pretax basis but more rewarding after tax. A basic principal of economics is that

[12] Tax revenues in both versions of the consumed income tax have the same present value. In the pre-paid version, the tax is $300 in the first year. In the other version, where the tax is $330 in the second year, its present value, discounted at 10 percent to the first year, is also $300.

when the relative price of something rises, the quantity of it that people want to buy declines. Because taxes raise the relative prices of taxed items, they lower the quantity demanded of those items.

Both a Haig-Simons income tax and a consumption-based income tax suffer from the drawback that they discriminate against work. As a result people work too little and spend too much time in leisure, given the productivity of their work.

To illustrate the bias against work, suppose that a person has the opportunity to work 100 extra hours in exchange for an added $1,000. If there is no tax on the earnings, the reward for work effort is $10 an hour and the cost of leisure is, therefore, also $10 per hour. If the person valued a forgone hour of leisure at anything less than $10, the $10 wage would be sufficient to induce him to work the extra hour. Now suppose the government imposes a 30 percent Haig-Simons income tax. After accounting for the tax, 100 hours of extra work only nets $700 of added income; $300 is siphoned off by the tax. Consequently, the after-tax reward for work effort drops to $7 an hour and the cost of leisure also declines to $7 per hour. If it took an extra wage of $10 to persuade the person to forgo an hour of leisure, clearly a $7 net wage will not be sufficient. Facing these skewed incentives, people naturally tend to work less than they otherwise would. A similar bias would exist if the government instead imposed a 30 percent pre-paid consumption-based income tax. The tax on $1,000 of earnings would be $300, leaving after-tax remuneration of $700. Again, the after-tax reward for work effort would drop by 30 percent to $7 an hour and the cost of leisure would also decline to $7 per hour.[13] In short, the consumption-based income tax and the Haig-Simons income tax are both biased against work and in favor of leisure.[14]

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[13] In present value terms, the other version of a consumption-based income tax would yield the same result, but tax liability would be deferred if the income was saved.

[14] Norman B. Ture, "Supply Side Analysis And Public Policy," in David G. Raboy, ed., *Essays In Supply Side Economics* (Washington, DC: Institute For Research On The Economics Of Taxation and The Heritage Foundation, 1982), pp. 16-18.

A Haig-Simons income tax carries the additional burden that it discourages saving and investment. This occurs because the Haig-Simons income tax double taxes saving relative to consumption, creating an anti-saving bias. Because saving and investment are leading contributors to improvements in productivity, the results of a tax bias against saving are less output, less international competitiveness, fewer jobs, poorer paying jobs, lower real wages, and smaller gains than would otherwise be achieved in productivity, employment conditions, and living standards.

Consider how the two tax bases affect the saving-consumption tradeoff. Suppose that a person earns an extra $1,000 and has the choice of using the funds for immediate consumption or for saving. Also assume that the market rate of return is 10 percent. In the absence of taxes, the person could devote the full $1,000 to current consumption or, by saving it, produce a $100 return in every future year. Thus, the cost of generating an extra $1 of annual income by means of saving would be the sacrifice of $10 of immediate consumption ($1,000 of current consumption / $100 annual return from saving).

With a Haig-Simons income tax, however, the initial earnings would fall to $700 after payment of tax. The person could then buy $700 of current consumption with this. Alternatively, the person could save this after-tax amount to produce a yearly return of $70. Because this return would itself be subject to tax under the Haig-Simons definition of income, the person's after-tax return would fall to $49. Hence, the person's after-tax tradeoff would be $700 of current consumption for $49 of annual future income. Equivalently, the cost of generating an extra $1 of annual income would rise from $10 of forgone present consumption ($1,000 / $100) to $14.29 ($700 / $49). This is a 43 percent increase in the relative cost of saving. The Haig-Simons tax makes saving more costly and present consumption relatively cheaper. The person faces a single tax if he consumes at once but a double tax if he saves.

With a pre-paid consumption-based income tax, the person's initial earnings would still decline to $700 after payment of tax. The person could use this amount for $700 of consumption purchases or, alternatively, save it and produce a $70 yearly return. Because the tax has been paid up front, the $70 yearly return on saving would not be subject to further tax. Accordingly, the cost of generating an extra $1 of annual income by means of saving would again be $10 of sacrificed current consumption ($700 / $70). Notice that with the consumption-based income tax the person pays the tax regardless of whether he consumes or saves, but the tax is not relatively heavier in one case than the other. In either case, the person is taxed once.[15] To recap, a Haig-Simons income tax raises the relative cost of saving (by 43 percent in the example) but a consumption-based income tax is even-handed.

As a result of its anti-saving bias, an income tax system based on the Haig-Simons concept of income consigns an economy to less output, growth, and prosperity than does a consumption-based income tax. Because the economic drag is felt throughout the economy, the anti-saving bias of a Haig-Simons income tax hurts people at all levels. It is ironic that a Haig-Simons income tax is, nevertheless, often defended on grounds of equity. If the goal is to soften the burden that the tax system imposes on lower income people, a tax system compatible with vigorous economic growth is more helpful to the poor than a tax system that severely weakens the economy: lower income people are usually the ones most vulnerable to a weak job market, and a strong economy provides more jobs at better pay than does a listless economy. Also, the poor are usually the class most dependent on government assistance programs, and historically benefits are more generous in a prosperous economy than in a sickly one.

Furthermore, a Haig-Simons income tax is blatantly unfair to people who save relatively more heavily than others. A Haig-Simons income tax discriminates against savers by taxing them twice, compared to the one time that it taxes those who opt for immediate consumption.

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[15] The neutrality of the consumption-based income tax in its effect on the costs of saving and consumption is evidence that it does not favor saving over consumption and should not be viewed as a tax only on consumption.

Another disadvantage of grounding a tax system on the Haig-Simons concept of income is that doing so produces an extremely complicated tax system. Under a Haig-Simons income tax, measuring saving and returns on saving with any accuracy is a difficult and tedious process. It places great paperwork burdens on taxpayers and requires an enormous number of rules and regulations that are highly technical and often ambiguous and arbitrary. It is no accident that most of the complexity in the current income tax system involves the tax treatment of saving and investment. Although a consumption-based income tax has its own complications, at least it does not have to measure both saving and returns to saving. For example, the current tax treatment of life insurance is simpler than it would be under a Haig-Simons income tax because policyholders do not have to maintain records on and include in their tax calculations the inside buildup that occurs within their policies each year.

Taxpayers who save encounter a further problem with a Haig-Simons income tax whenever there is inflation — which is most of the time — in that they probably are taxed on inflationary gains. Although it is often recognized that saving and returns on saving should be adjusted for inflation in order to measure the Haig-Simons tax base accurately, the needed corrections can entail a large number of additional computations, particularly for taxpayers with many assets. Accordingly, advocates of the Haig-Simons tax base often urge that the inflation correction be forgotten, with the result that real and purely inflationary gains would both be taxed. Simons uncomfortably expressed the awkwardness of this position. On the one hand, he felt that "considerations of justice demand that changes in monetary conditions be taken into account"; on the other hand he recommended that the matter be "let alone" because it was too complicated.[16] He told people to "abandon hope of correcting [the tax system] for instability [of prices] through special income tax devices."[17]

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[16] Simons, *op. cit.*, p. 155.

[17] *Ibid.*

By way of illustration, suppose a person earns $1,000, pays a 30 percent tax on it, and invests the after-tax $700 at 10 percent interest. Also suppose the inflation rate is 5 percent. By the start of the second year, the investment will have grown to $770. Because of inflation, however, $735 of that is needed just to provide the same purchasing power that $700 furnished initially. Thus, the real return on saving (in year 2 dollars) is only $35, not $70. In the absence of further taxes, the real return would remain $35. With a Haig-Simons income tax that corrects for inflation, the 30 percent tax would be levied on $35, leaving an after-tax real return of $24.50 after payment of the $10.50 tax. With an uncorrected Haig-Simons tax, though, the tax would be levied on the unadjusted return of $70 (twice the real return), leaving an after-tax real return of just $14.00 after payment of the $21.00 tax.

A consumption-based income tax, in contrast, effortlessly avoids the trap of taxing inflationary gains as though they were real. In the pre-paid version, which the present tax treatment of life-insurance-product policyholders comes close to meeting, the initial $1,000 would be taxed, but no tax would be assessed on the $70 return and, consequently, there would be no need for tax purposes to distinguish between the return's real and inflationary components. (In the other version, the initial $1,000 would not be taxed if saved, allowing it to grow to $1,100 by the start of year 2. If the funds were then withdrawn, the gross return of $1,100 would be taxed at a 30 percent rate, leaving $770, which is the same end result as with the pre-paid version.) In terms of rates of return, the real rate of return under the consumption-based income tax would be 4.76 percent ($35 real return in year 2 / $735 initial investment expressed in year 2 dollars). The real rate of return under a Haig-Simons income tax that indexed for inflation would fall to 3.33 percent ($24.50 / $735). The real rate of return under a Haig-Simons income tax that failed to adjust for inflation would suffer a further drop to 1.90 percent ($14.00 / $735). The higher the inflation rate, the lower this return would fall.[18]

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[18] If there were no income tax at all, the person could invest the full $1,000 initially and receive $1,100 at the start of year 2. Because the initial saving would be worth

For many reasons, then, income used for consumption is a superior tax base to Haig-Simons income.[19]

The GAO and Treasury Reports Call for Greater Taxation of Policyholders

As part of the Technical And Miscellaneous Revenue Act Of 1988, Congress directed the General Accounting Office and the Department Of The Treasury each to prepare a report on

> "(1) the effectiveness of the revised tax treatment of life insurance and annuity products in preventing the sale of life insurance primarily for investment purposes, and

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$1,050 in year 2 dollars, the real return would be $50. Expressed in percentage terms, this would be $50 / $1,050 = 4.76 percent, which is the same real rate of return provided by the consumption-based income tax.

[19] Another difficulty, which Simons was honest enough to note, is that the Haig-Simons tax base should logically include imputed income from consumer durables (owner-occupied housing, automobiles, clothing, and a wide assortment of other personal property). In this view, consumers are looked upon as owners of valuable property who happen to rent the property to themselves. When owners and consumers are separate parties, the rents are explicit. For example, a landlord collects rent from a tenant and includes the rent less deductible expenses in taxable income. It is argued that when the owner and the consumer are the same person, there is still income but it is imputed. This in-kind income, it is argued, belongs in the Haig-Simons tax base. As a bow to his notion of practicality, though, Simons would have included in-kind income only "from the more durable forms of consumer capital used by the owner" in his recommended tax system (*Ibid.*, p. 211). A consumption-based income tax has the advantage that by its nature it sidesteps this confusing and ambiguous area. If people buy consumer durables with after-tax dollars, that has the character of a pre-paid consumption-based income tax. Any returns on the durables (in terms of the in-kind benefits they provide) should not be subject to further tax. Thus, consumer durables are not a problem in the setting of a consumption-based income tax.

> (2) the policy justification for, and the practical implications of, the present-law treatment of the earnings on the cash surrender value of life insurance and annuity contracts..."[20]

Both questions refer to how the individual income tax treats those who hold cash value life insurance policies or annuity contracts. The first query asks whether the tax code generally prevents investors from obtaining the tax treatment accorded to life insurance policies or annuity contracts on products that are, in actuality, mainly unrelated to life insurance or annuity policies. Congress's second query is whether there is a good public-policy basis for the normal, long-standing practice of not taxing policyholders on the unrealized returns within their policies.

In response to the first question, the GAO Report does not see any urgent problem and does not make any recommendation for change. It notes that the restrictions added to the tax code in the 1980s have curbed sales of the products, like single-premium life insurance, that some perceived as having the largest investment elements.

The GAO Report also explains that although insurance coverage may not be the only reason why some products appeal to buyers, it is an essential component. In the case of one type of cash value life insurance, the GAO Report says, "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." [emphasis added][21] In other words, these products' insurance coverage is not mere window dressing but a major reason for the products' appeal. Although some other types of life insurance products rely more heavily on investment returns than do whole life policies, none of them is a particularly attractive investment to policyholders if it is judged without taking account of its insurance benefits.

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[20] Commerce Clearing House, Federal Tax Guide Reports, Vol. 72, No. 5, CCH Special 8, *Technical And Miscellaneous Revenue Act Of 1988, Law and Explanation*, (Chicago, IL: Commerce Clearing House, November 7, 1988), p. 992.

[21] *GAO Report*, p. 39.

The GAO Report insists, however, that it cannot assure Congress that no insurance products are sold mainly for non-insurance purposes. The problem, says the GAO, is that Congress has worded the question too vaguely. In criticizing Congress's question, though, the GAO Report replaces the word "primarily" in the actual question with the much broader and more ambiguous phrase "too investment oriented" and then says, in effect, who knows what that means. "Other than the legal definition, no criteria exist for distinguishing which ... 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."[22] One conclusion that can be reached from the GAO Report's waffling, however, is that it has found no clear-cut evidence that any insurance product which passes the tax tests introduced in the 1980s is primarily non-insurance oriented.

There is also a more fundamental problem with the question, although neither the GAO Report nor the Treasury Report considers it. An unstated premise in the question is that the tax treatment of insurance products is exceptionally generous and that this treatment should not be extended to other financial assets. In fact, as explained earlier, the tax treatment of insurance products is not exceptionally generous but is roughly consistent with how saving should be taxed in order to avoid an income tax bias against saving. Accordingly, even if some types of insurance products have non-insurance elements, the way the products are taxed now is close to correct. It would be undesirable to charge policyholders higher taxes on those products.

The Treasury Report expresses far more misgivings about possible tax abuses of life insurance products than does the GAO Report. The Treasury Report reaches its conclusions, though, by taking extremely narrow and arbitrary positions regarding what properties life insurance policies and annuities ought to possess. In particular, the Report charges that most annuities are not "true" annuities but abusive tax arrangements.

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[22] *Ibid.*, p. 33.

The Treasury Report insists that the defining characteristic of an annuity is that of "preventing the annuitant from outliving his assets."[23] The only type of annuity entirely consistent with this function, says the Treasury, is one making periodic payments to the annuitant over the annuitant's lifetime (straight life annuity). Most annuities, however, are not of this type; policyholders generally prefer more options. It is very common that annuities allow distributions to be made in a lump sum or over a specified number of years. Even on policies that continue for life, the policies often guarantee a certain minimum number of payments to the annuitant and his heirs.

The Treasury Report admits that its very restrictive proposed definition is at variance with both tax law and common tax practice.[24] But, despite this lack of support, the Treasury recommends that long-standing law and practice be abruptly overturned and that the overwhelming majority of annuities be reclassified as combinations of "true" annuities and currently taxable investments.[25]

The Treasury Report contains a long examination of sales trends for various types of life insurance products.[26] It finds that annuity sales have increased since the middle of the 1970s as a percentage of total life insurance company sales, with the increase particularly marked since 1986. Because the Treasury Report has adopted such a drastically narrow definition of annuities, it regards most annuities as abuses of the tax system. The trend, declares the Treasury Report, is evidence that the abuse is worsening and that Congress ought to act. It should be recognized, however, that the supposed

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[23] *Treasury Report*, p. 16.

[24] *Ibid.,* p. 14.

[25] The Treasury Report, in an arbitrary exception to its arbitrary proposed rule, would allow some annuities that guarantee a minimum number of payments to annuitants and heirs still to qualify as "true" annuities if the guaranteed number of payments is relatively small. (*Ibid.*, p. 54.)

[26] *Ibid.*, pp. 29-37.

abuse stems entirely from the Treasury Report's peculiar definition of "true" annuities. Under a more conventional definition, annuities are not abusive and their increased popularity should not be taken as justification for restrictive tax changes.[27]

In asserting that tighter rules are needed regarding the tax definitions of life insurance products, the Treasury Report also condemns consumer choice. According to the Treasury Report, innovations by life insurance companies have given policyholders more choices ("choices of alternative investments within a life insurance contract", "more choices of investment strategy", "more choices in the setting of the level of premium payments and the level of death benefits"), and those added choices have made life insurance "a more attractive investment vehicle for individuals and corporations than previously."[28] The Treasury Report is even more disapproving when it

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[27] The rise in annuity sales, by itself, is not an indication that any tax abuse is present. As the Treasury Report notes in a caveat, "[R]ecent trends may also reflect ... other factors, such as changes in market rates of return ... and demographic changes." (*Ibid.*, p. 29.) Greater consumer familiarity with annuities may also be a factor. A market economy is extremely dynamic. Countless products rise in popularity for a variety of reasons while many other products become less popular and fashionable. If tax authorities were to become suspicious merely on the basis of trends, they could uncover "evidence" of tax abuses in virtually every corner of the economy.

Furthermore, even if people do modify their behavior in response to tax changes, that is no indication that people are abusing the tax system. (Often, people believe the tax system is abusing them.) For instance, if one type of insurance product is taxed more heavily, people will naturally turn to other insurance products (and probably reduce their total purchases of insurance products.) The resulting changes in sales, caused by heavier taxation of one product, are evidence that people respond to incentives, including those of the tax system; the changes are not evidence that other insurance products should be taxed more heavily. (If tax legislation were driven by such trends, those in government who wish to raise taxes would have a handy tool, after raising taxes on one product, for ratcheting up taxes on all the substitute products to which people turn.)

[28] *Ibid.*, p. 17.

summarizes the numerous choices now available to annuity holders.[29] In this connection, the Treasury Report expresses no concern whatsoever about the virtual straight jacket regarding the timing of distributions into which its annuity proposal would force most annuity buyers. The Treasury's hostility towards product innovation is completely contrary to what is generally regarded as commendable business practice. Businesses are supposed to respond to customers' wants; that is how they maintain their competitive edge and service their customers better. (Ironically, government officials frequently make this exact point in discussions of productivity and international competitiveness.) Rather than viewing vigorous product innovation as cause for restrictive tax legislation, which is the Treasury Report's position, a richer menu of choices should be seen as a highly positive development.

In turning to Congress's second question, the policy justification for the tax deferral on inside buildup, the GAO Report accepts without analysis the Haig-Simons definition of income (though it does not explicitly use the term). Based on the Haig-Simons definition, the GAO Report then asserts that inside buildup is current income to policyholders. "Economic income for a household is defined as the sum of its consumption spending plus the change in its net worth... According to this definition, the interest that accumulates on a life insurance policy is income [to the policyholder] — though income that may not be received in cash."[30] The GAO Report further supposes, again without analysis, that Haig-Simons income is the ideal income tax base and that every component of Haig-Simons income should be taxed unless doing so would be administratively impractical, create grave hardships for taxpayers, or contravene crucial public policy goals. The GAO Report's position is that none of these problems is particularly severe in the case of life insurance products. It insists, for example, that a policyholder of modest means would be only slightly inconvenienced if he or she were suddenly required to add several hundred dollars to his or her taxable income every year and then forced to pay current taxes on that imputed amount. The

[29] *Ibid.*, p. 18.

[30] *GAO Report*, p. 38.

GAO Report states, "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."[31]

The GAO Report concedes "only one ... potential merit" for the current tax treatment: "[W]ithout this preference, people may not provide their dependents with adequate insurance protection or themselves with sufficient retirement income."[32] The GAO Report takes a similar position with respect to annuities. This concern, one might well believe, should very substantially outweigh the GAO Report's criticisms regarding the existing tax treatment of policyholders. The gains to the nation from conforming the tax treatment of life insurance and annuity policies with the Haig-Simons income concept are not identified in the GAO Report. On the other hand, the adverse effects of subjecting policyholders to Haig-Simons tax treatment are potentially of such magnitude that those proposing to do so should be required to show either that the negative effects are small or that the real benefits of taxing policyholders according to the Haig-Simons concept of income outweigh the adverse effects. Instead the GAO Report simply remarks that it is difficult to estimate by how much policy ownership would fall and says weakly that the negative impact of higher taxes on policy ownership is one of the considerations Congress may wish to take into account.[33] The GAO Report then goes on, without any attempt at estimating the negative tax effect, to suggest various tax changes that would adversely affect policyholders.

If Congress is not willing to tax inside buildup, the GAO recommends that at the minimum people who borrow against cash value life insurance

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[31] *Ibid.*, p. 39.

[32] *Ibid.*, p. 3.

[33] The Report states at one point, "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." (*Ibid.*, p. 43.) At another point it states, "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." (*Ibid.*, p. 4.)

policies be forced to count the borrowed funds as income, be required to pay regular tax on that "income", and that they also be charged a penalty tax (as punishment, according to the GAO, for not having paid tax on inside buildup earlier). "Congress may want to periodically reconsider its policy decision to grant preferential tax treatment to inside buildup ... If Congress decides not to tax inside buildup, then GAO recommends that Congress eliminate tax-free borrowing of life insurance proceeds ... [and add] a penalty provision ... to the regular tax [on the borrowings]."[34] Notice that the Report describes a loan backed by a life insurance policy as a "tax-free borrowing of life insurance proceeds". This wording obscures the difference between a loan collateralized by an asset and an actual distribution from the asset. The GAO notes approvingly that funds borrowed against annuities are already subject to tax.

The GAO analysis is grievously flawed by its uncritical acceptance of Haig-Simons income as the ideal tax base. There is no recognition in the Report that Haig-Simons income is, in reality, an inefficient and unfair tax base that is strongly biased against saving and investment. Because the GAO Report uses a warped measuring rod, it incorrectly judges that tax deferral on inside buildup is a "subsidy or tax preference" to policyholders. Contrary to the GAO Report's fundamental proposition, a much better tax standard is consumption-based income. Viewed against that improved measuring rod, policyholders are not receiving a government subsidy, at all.

The GAO Report's demand that life insurance policyholders be taxed immediately on any borrowings from their policies (and assessed a penalty tax, to boot!) is also unjustified.[35] Contrary to the GAO's assertion, it is

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[34] *Ibid.,* p. 46.

[35] Beyond claiming that policy loans are payments from the policies, the GAO arbitrarily insists that when a policyholder obtains a loan from his or her life insurance carrier, the loan amount comes from inside buildup first and, only after inside buildup has been exhausted, from principal. The GAO's ordering is opportunistic in that it deliberately maximizes policyholders' potential tax liabilities by always putting taxable withdrawals of income before nontaxable returns of principal.

anything but obvious that a loan should be regarded as a realization of income from the collateral that backs the loan. Although there are some exceptions, the general tax practice is not to regard loans as income. People can normally use stocks, bonds, and other property as collateral for loans without being taxed on unrealized appreciation in the value of the collateral.[36] For instance, when a person obtains a bank loan by pledging home equity as collateral, the tax system does not treat the loan as a partial sale of the home and it does not tax the loan amount as income to the homeowner. It would be a profound change in long-standing income tax practice if collateralized borrowings suddenly were classified as income to borrowers. Yet, that is exactly what the GAO Report urges in the case of life insurance products.[37]

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[36] Also see Anderson, *Tax Notes*, p. 1430.

[37] Ironically, if the overall tax system were a consumption-based income tax and if it were of the type that deducts saving from the tax base while adding back to the tax base gross returns to saving, it would make sense to tax borrowings (including loans backed by life insurance products). The explanation is that the saving deduction is for an individual's net saving, and net saving is reduced by how much a person borrows. In an earlier example, it was assumed that a person saves $3,000 during the year but borrows $2,000. Thus, the person's net saving is $1,000. With the type of consumption-based income tax that allows a deduction for saving, this could be handled by allowing the individual to deduct the $3,000 of saving but also requiring the individual to add back into the tax computation the $2,000 that was borrowed. The net tax deduction, $1,000, would equal the person's net saving.

Unless the tax system is thoroughly transformed, however, this procedure should <u>not</u> be followed with respect to loans backed by life insurance products. Although a few elements of the tax system resemble a consumption-based income tax with a deduction for saving (IRAs come to mind), the tax system in general does not allow a deduction for saving and, hence, should not require an addition for borrowing. (Anderson, *op. cit.*, pp. 1429-1430, also makes this point.) With regard to the tax treatment of life insurance products in particular, policyholders are not allowed to claim a tax deduction for their premium payments. If the government ever changed the tax code so that policyholders could deduct their premiums, then it would be consistent to require policyholders to pay tax on policy-backed loans. But in the absence of that deduction, policy-backed loans do not belong in policyholders' tax bases. The recommendations in the GAO and Treasury Reports are one-sided in that they seek to tax policyholders on policy-backed loans without permitting the policyholders any deduction for premium payments.

The change would also contradict the perception of most individuals that there is a basic difference between loans and income — and that the tax code should recognize the difference.

If borrowed funds were recategorized as income, consider also the treatment that would then be appropriate to the other party to the loan transaction — the lending insurance carrier. If the borrower received income by borrowing, the insurance carrier should be allowed a deduction for the cost of lending.

To be sure, annuity holders are taxed on borrowings. But rather than treating annuity borrowings as the model to which other parts of the tax system should conform, it is the current tax treatment of annuity borrowings that ought to be reexamined. Their treatment is a major anomaly compared to standard tax practice.

The Treasury Report uncritically accepts the Haig-Simons definition of income (also like the GAO Report without explicitly using the term) and pins its entire analysis on that definition. The Treasury Report gives absolutely no indication that there are other possible definitions of income. Similarly, the Treasury Report provides no warning whatsoever that if taxes are imposed on both ends of the saving stream (saving and returns to saving), the result will be a tax bias against saving. Far from cautioning that many provisions of the tax code discourage saving and that ending or curtailing the tax deferral on inside buildup would compound the damage, the Treasury Report instead misidentifies the high-spending, debt-ridden government as a vigorous booster of saving. "A number of current and proposed government policies are designed to increase national saving."[38]

The Treasury Report is at least as vehement as GAO's in its contention that loans backed by life insurance policies ought to be taxed. Again, the crucial but highly debatable assumption is that using an asset to provide collateral for a loan is the same thing as realizing income in taking the funds directly out of the asset.

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[38] *Treasury Report*, p. 42.

Still on the subject of loans, the Treasury Report says, "[A]nother option that should be considered is the elimination of the deduction for interest on loans that are secured by corporate-owned life insurance."[39] (Corporate-owned life insurance (COLI) are life insurance policies that businesses take out on the lives of employees with the businesses as beneficiaries.) Treasury's objection is that loans backed by COLI are not taxable while interest charges on the loans are deductible. Supposedly, this creates a tax shelter. "[B]ecause interest on loans secured by life insurance contracts is generally deductible by businesses, businesses may use such loans to shelter other income from tax."[40] The Treasury's position directly contradicts widely accepted, long-established tax principles and practices. A basic principle of the income tax system is that borrowed funds are not income. Another related, basic principle is that the tax should be assessed on income, not borrowings. A third basic principle is that in computing net income a business should be able to deduct the expenses it incurs in the course of doing business. The interest payments that businesses make on their borrowings are a major category of such expenses.

In ignoring these principles, the Treasury Report tries to link the interest payment directly to the insurance policy and says that if the policy is not currently taxed, then, for symmetry, the interest payment should not be deductible. "This sheltering, or tax arbitrage, occurs because the allowance of a deduction for the interest, while the corresponding inside buildup is not taxed currently, permits businesses to reduce otherwise taxable income by the amount of the interest expense."[41] Even on its own terms, this argument is incorrect. The argument gives the deceptive impression that income is dropping out of the tax base. What the Treasury Report conveniently neglects to explain is that interest payments are normally considered income to the lender and must be included in the lender's tax base. The Treasury Report's proposal would strip borrowers (in this case corporations who use

[39] *Ibid.*, p. 41.

[40] *Ibid.*, p. 22.

[41] *Ibid.*, p. 22.

life insurance policies as collateral for loans) of the interest deduction while continuing to tax lenders (in this case insurance carriers who lend the funds) on the interest income.

The "Tax Expenditures" Budget Is Wrong

Every year the federal budget document draws attention to the current tax treatment of life insurance products by including the "exclusion of interest on life insurance savings" in its list of "tax expenditures". According to the budget's authors, "tax expenditures" should be regarded as government subsidies that happen to be delivered through the tax system. "`Tax expenditures' are revenue decreases (relative to yields that it is assumed might otherwise be achieved) due to preferential provisions of the Federal tax laws..."[42] And if "tax expenditures" are government subsidies, the argument continues, they should be seen as "an alternative to other Government policy instruments, such as direct expenditures and regulations."[43] As part of the budget process, so the argument goes, it should be determined whether each "tax expenditure" is worth the cost. If it is not, the preference should be ended. Likewise, if another government policy instrument would do the job better, the preference should be ended and replaced with the other policy instrument.

But this whole line of reasoning puts the cart before the horse. A "tax expenditures" budget will point to unsound tax policies if it relies on an unsound tax baseline. For example, if the government adopts a baseline that is biased against a particular activity, neutral tax treatment would show up as a "tax expenditure" while the absence of a "tax expenditure" (measured against the deceptive baseline) would mean that the tax system, in reality, discriminates against the activity.

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[42] Office Of Management And Budget, *Budget Baselines, Historical Data, And Alternatives For The Future*, Appendix Two, Tax Expenditures (Washington, DC: Government Printing Office, January 1993), pp. 543.

[43] *Ibid.*

The use of an improper baseline is exactly the criticism that should be directed against the inclusion of life insurance products in the "tax expenditures" budget. The baseline to which the government compares the tax treatment of life insurance products calls for taxing both saving and the returns on that saving. Such a baseline, as explained previously, is biased against saving. Any attempt to change the tax treatment of life insurance products so as to reduce the "tax expenditure" (measured against the government's skewed baseline) would guarantee that the tax system would discriminate against holders of cash value life insurance and annuity policies, discouraging the use of those products. Because of various provisions in the tax code, the tax system already strongly discriminates against saving, and the implicit recommendations in the "tax expenditures" budget would greatly intensify this anti-saving prejudice.

A better baseline would be income used for consumption, which is not biased against saving. If the "tax expenditures" budget were recomputed using that more neutral benchmark, the supposed "tax expenditure" involved in the treatment of life insurance products would disappear. (As mentioned already, life insurance products are actually somewhat overtaxed relative to a model income tax based on income used for consumption.)

In his paper, Anderson strongly argues for such a substitution, saying that income used for consumption is a far more reasonable reference standard than Haig-Simons income.[44] Anderson also uses his close examination of the life insurance case as an example to indicate that many of the provisions of current law now listed as "tax expenditures" are really not tax subsidies; it is only the bias contained in the benchmark tax model that creates that illusion. Anderson recommends that the "tax expenditures" budget be reformulated by replacing Haig-Simons income with income used for consumption as the benchmark.

Actually, Anderson gives the "tax expenditures" budget too much credit when he accepts the notion that its foundation is a pure and rigorous model tax system (albeit the wrong one). In reality, the "tax expenditures" budget

[44] Anderson, *op. cit.*

is not grounded on a theoretically coherent tax base of any sort. Legally and in practice, "tax expenditures" are calculated by reference to an ad hoc, arbitrary "normal tax system" that is based partially on the actual corporate and individual income taxes and partially on the views of those who developed the "tax expenditures" concept in the first place. Thus, the results say very little about good tax policy and a great deal about the items that were arbitrarily included or excluded from the "normal tax structure".

To be sure, government documents often imply that the "tax expenditures" concept possesses theoretical precision. The budget statement issued in January 1994 is typical. It states, "The normal tax baseline is patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time."[45] It does caution, however, that "deciding whether provisions are preferential exceptions ... is a matter of judgement" and acknowledges that the government's so-called normal baseline has "several major departures from a pure comprehensive income tax."[46]

An earlier federal budget was much franker in spelling out just how subjective the government's "normal tax" standard really is. Although "tax expenditures" are

> "defined in the legislative history of the Congressional Budget Act as exceptions to the `normal structure' of the individual and corporate income tax ... the `normal structure' is <u>not</u> defined in the tax code. The concept has evolved in recent years from various congressional and public reviews of the U.S. tax system focusing on the definition

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[45] *OMB, Budget Of The United States Government, Analytical Perspectives, Fiscal Year 1995*, p. 64. This is, of course, a paraphrase of the Haig-Simons definition.

[46] *Ibid.*

> of the income tax base and the rates applied to that base."[emphasis added][47]

Lest there be any lingering belief that the allegedly "normal" tax is solidly founded in coherent tax theory, the explanation continued:

> "Conceptually, it would be more appealing to begin with a theoretically pure tax structure as a standard ... However, this is not possible ... [For example,] the normal structure includes the separate taxation of individuals and corporations whereas a theoretically pure tax structure would integrate these two income taxes ... [And] existing rates are accepted even though there is no theoretical foundation upon which to support any particular degree of progressivity ... [Further,] when the rate structure is changed, for whatever reason, the new rates become part of the new normal structure..."[48]

Different assumptions from those in the "normal tax structure" would produce a very different set of "tax expenditures". How can sound tax policy be based on such amorphous standards?

Moreover, the "tax expenditures" budget has a bias in favor of overtaxation, especially on the returns to saving and investment, because it never subtracts out taxes that are excessive when compared to a pure income or consumption standard. For instance, a theoretically pure tax, whether based on income or consumption, would not tax income at both the individual and corporate levels. Given the presence of the individual income tax, the additional corporate income tax simply does not belong in a theoretically pure model tax system. Since the corporate income tax should not even exist in a pure system, one implication is that <u>no</u> corporate income tax provisions should be listed as "tax expenditures". If anything, because the

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[47] Office Of Management And Budget, *Special Analyses, Budget Of The United States Government, Fiscal Year 1977*, Special Analysis F (Washington, DC: Government Printing Office, 1976), pp. 116-117.

[48] *Ibid.*

corporate income tax is excessive relative to a theoretically pure baseline, it might be appropriate to list corporate tax payments as "negative tax expenditures" (i.e., tax penalties). If either of these changes were made, the dollar amounts listed in the "tax expenditures" budget would immediately become much smaller and many items now classified as "tax expenditures" would need to be reclassified as cases of overtaxation.

As another illustration, the "tax expenditures" budget would change profoundly if the higher individual rate brackets were counted as tax penalties on the upper-middle class and wealthy or if the lower brackets were counted as tax expenditures for the poor. Given that all individual rate brackets are now treated as part of the "normal tax structure", it is certainly grossly inconsistent that the lower rate brackets of the corporate income tax are counted as "tax expenditures". This inconsistency further emphasizes the arbitrary character of the baseline. The realization that the "tax expenditures" budget has such a nebulous starting point and relies so heavily on the judgements of those who prepare the "tax expenditures" list should make one very wary about accepting its results uncritically.

The existing "tax expenditures" concept is further compromised because it cannot be made operational without overcoming extremely thorny measurement problems. For example, if the existing "tax expenditures" list is to be quantified, the revenues lost as the result of each "tax expenditure" must be determined. The revenue estimation process, however, is very challenging technically. And the government's official revenue estimation models are especially poorly suited to the task because they falsely assume that the incentive changes produced by taxes cause no changes in the overall pace of economic activity.[49]

In light of the extreme weaknesses of the "tax expenditures" concept, one should question the characterization of any provision of current law as a "tax expenditure" unless the government can first present the most thorough analytical justification. Although reforming the "tax expenditures" budget

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[49] For a detailed discussion of the various problems of the "tax expenditures" concept, in theory and practice, see Ture, *Tax Expenditures*.

along the lines of a consumption-based income tax would be better than nothing, the problems of defining "tax expenditures" objectively and estimating their magnitude accurately are so formidable that it would be still better to drop the concept entirely.[50]

Is Consumption A Valid Measure Of Income?

Notwithstanding the desirable properties of income used for consumption as a tax base, some would regard it as an indicator of only consumption, not income. Actually, consumption-based income is an entirely valid measure of income. Despite the word "consumption" in its name, a consumption-based income tax does not tax consumption *per se*; it merely avoids taxing both the capitalized amount of future income — saving — and the future income itself.

Attempts to define income often lead to confusion and disagreement because there is no unique measure of income. Arguments have been made on behalf of both Haig-Simons income and consumption-based income. Simons himself explained that personal income, as he defined it, was only one of many possible definitions. He also mentioned "income from things", "gain from transactions", "social or national income", and examined a long list of definitions put forward by other writers. In deciding how he wanted to define income, Simons was guided by "the ethical or aesthetic judgement that the prevailing distribution of wealth and income...is distinctly evil or unlovely."[51] Simons felt that the central purpose of an income tax should be wealth and income redistribution. "[W]e shall assume that moderation of inequality is an important objective of policy and proceed to consider income taxes as devices for effecting it.... [Income's] meaning may be sought by inquiring what definition would provide the basis for most nearly equitable

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[50] Anderson does not mention the "tax expenditures" budget's shaky theoretical roots, its bias toward overtaxation, or its measurement problems. He would strengthen his case if he did.

[51] Simons, *op. cit.*, p. 19.

levies."[52] Simons acknowledged, incidentally, that his ideal tax would have "significantly adverse" effects on capital accumulation, production, and the size of national income.[53] With his fixation on people's relative positions of wealth and income, however, he brushed aside as unimportant the associated declines in the absolute level of output and the rate of economic progress for the society as a whole.

In contrast to Simons, another noted American economist, Irving Fisher, favored "income spent" as the tax base precisely because he thought it provided a better measure of income than did an accretion-style income tax.[54] In Fisher's view, an accretion-style definition of income is flawed because it counts the same income flow twice. In one analogy, Fisher compared saving to a tree and returns on that saving to fruit from the tree.[55] In this physical example, said Fisher, an income tax could be levied correctly by imposing a charge on the fruit, but not the tree. Although the tree does have value, that is solely attributable to the fruit it produces. Alternatively, since the value of the tree is the discounted value of the income that will come from its fruit, the income tax could be placed on the tree. It would be taxing the same income twice, however, to tax the tree and, later, the fruit. More generally, said Fisher, saving should not be regarded as income in its own right; it is the returns on saving that constitute income. According to Fisher, a tax properly assessed on income should tax either the returns on saving or the initial saving that will later produce the returns. A tax constructed according to Fisher's definition of income has the same base as a consumption-based income tax and affords neutrality between saving and consumption.

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[52] *Ibid.*, pp. 41-42.

[53] *Ibid.*, see pp. 19-21.

[54] See Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation* (New York: Harper & Brothers, 1942). Also see Irving Fisher, *The Nature Of Capital And Income* (New York: Augustus M. Kelley, 1965, Reprint of 1906 original edition); and Irving Fisher, *The Theory Of Interest* (New York: MacMillan Company, 1930).

[55] Fisher and Fisher, *Constructive Income Taxation*, page 57.

Additional Issues

Anderson's study offers several secondary defenses for the current tax treatment of life insurance products. It is worth examining the strengths and weakness of several of these fallback positions. Many of his arguments have merit, although they are not, by themselves, a substitute for the main line of analysis.

Many forms of saving receive full or partial "consumption tax" treatment

Numerous investments are taxed in a manner that is consistent, in whole or part, with a consumption-based income tax.[56] For instance, when people channel saving through qualified pension plans and deductible IRAs, they are not taxed on the saving or returns to that saving until they withdraw the funds (when they are fully taxed on the gross distributions.) That is classic consumption-based income tax treatment. Municipal bonds illustrate the prepaid version of the consumption-based income tax: people generally buy municipal bonds with after-tax dollars and are not liable for taxes on subsequent interest payments. Many other assets, including stocks, corporate bonds, and real property can be thought of as receiving partial consumption tax treatment in the sense that there is limited tax deferral on returns to saving: people are generally not taxed on capital gains until they dispose of the assets.[57]

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[56] For a detailed listing and discussion, see Anderson, *op. cit.*, pp. 1421-1424.

[57] Anderson includes education in his catalog of investments that allegedly receive full consumption tax treatment. On that one entry, he is wrong. For education to receive consumption tax treatment, either an individual's expenditures on education would have to be immediately deductible from income or the increased future earnings attributable to the education would have to be exempt from tax. In fact, an individual's education expenditures are not deductible and the individual's increased earnings are taxed. Anderson claims that education enjoys consumption tax treatment because the costs of education are heavily subsidized by government and tax-exempt charities. But government and charitable spending programs should not be confused with how the government taxes individuals on their activities.

The comparison of the tax treatment of life insurance products with many others forms of saving deflates the assertion made in the Treasury Report that "life insurance and annuity contracts remain tax favored relative to most alternative investments."[58] The current tax treatment of life insurance products is not unusual or out of line with that specified in many other parts of the tax system. A corollary, which Anderson also discusses, is that taxing life insurance products more heavily would put them at a competitive disadvantage compared to some other investment products.[59] Such adverse treatment, besides reducing the overall quantity of saving, would disadvantage policyholders and insurance carriers and would further distort the ways in which people save.

The shortcoming of the argument that a tax practice ought to be retained because it is widespread, which Anderson does not mention, is that a particular tax practice is not proven right because it is common (nor proven wrong if it happens to be rare.) Advocates of stiffer taxation of life insurance products might simply contend that many investments are taxed improperly. This attitude is frequently encountered in tax-writing committees and the U.S. Treasury Department. Proper tax policy should be decided according to sound tax principles, not what is most common.

Establishing that a tax rule is common or has a long history indicates that it should not be cast aside casually but is often insufficient to protect it. Congress has frequently overturned long-established tax practices or barred participants in one industry or activity from using rules that remained available elsewhere. Sometimes Congress makes wholesale tax changes, as occurred with the Tax Reform Act Of 1986. More often, one or a few

[58] *Treasury Report*, p. 2.

[59] Anderson declares emphatically that because life insurance products are long-term investments, they should only be compared to other long-term investments, not to short-term assets. This seems overly restrictive. Although long-term assets may be closer substitutes for life insurance products than short-term assets, there is still some substitutability between long- and short-term assets, as many Americans demonstrated in the early 1990s in response to extremely low short-term interest rates.

provisions are changed at a time. Complaints that piecemeal changes lead to inconsistencies are usually ignored or brushed off with the rationalization that the inconsistencies are of minor consequence next to the alleged benefits.

Impact of inflation

Because the U.S. tax system fails to index saving and returns on saving for inflation, the real tax rate exceeds the nominal tax rate, often substantially. Anderson contends that once the tax on fictitious gains is factored in, the real after-tax return on life insurance products is roughly the same under current law as it would be under a pure Haig-Simons income tax with an inflation adjustment. His conclusion is that even if one seeks a pure accretion-style income tax, the current tax treatment of life insurance products is appropriate because it approximates a Haig-Simons income tax that corrects for inflation.[60] Anderson also argues that OMB's "tax expenditures" calculations are defective because they take no account of inflation.

It is stated in the federal budget that inflation adjustments should be made to the cost basis of assets and debt ("A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the price level during the time the assets or debt are held.") but that, in a departure from the comprehensive income tax baseline, the adjustments are not made.[61] (As Anderson points out, a consumption-based income tax is much less vulnerable to inflationary distortions. A "tax expenditures" budget computed

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[60] Anderson shows with examples that the interaction between inflation and an unindexed income tax especially erodes the real after-tax returns on investments with low market rates of return. Anderson claims that insurance products are in this category and, therefore, are particularly deserving of an inflation offset. But if an asset offers a low market return compared to other assets and if investors are satisfied with that return, the asset must be giving investors other benefits. Until it is determined how inflation affects those other benefits, one cannot be sure how strongly the interaction of inflation and taxation affects the asset's attractiveness.

[61] *OMB, Budget Of The United States Government, Analytical Perspectives, Fiscal Year 1995*, p. 64.

with a consumption-based income tax as its baseline would not require inflation indexing of the cost basis of assets and debt to be accurate.)

One possible rejoinder to Anderson's argument, however, is that if the objective is to correct for inflation in the context of an accretion-style income tax, the only accurate technique for doing so regardless of the inflation rate is through inflation indexing. A combination of deferrals and exemptions that is just right at, say, a medium inflation rate would be too generous at a low inflation rate and inadequate at a high inflation rate.[62] Those who seek to tax insurance products more heavily could say that if current law was once justified as a crude inflation offset, it is no longer needed now that inflation has subsided from the highs of the 1970s and early 1980s. While complaining that the current offset has become too generous, they could also assert that any future tax adjustments for insurance products should be made through indexing or not at all.

It is worth remembering in this regard that the capital gains differential was once defended as a rough adjustment for inflation. That argument did not carry much weight in 1986 when Congress (unwisely) eliminated the differential.

With respect to the calculation of "tax expenditures", the government bureaucrats who are the arbiters of what comprises the "normal tax structure" have decided not to index assets and debt for inflation. And there is virtually no prospect that they will choose to do so in the future, barring explicit Congressional legislation. Thus, an inflation offset has no relevance with respect to the actual "tax expenditures" budget.

[62] Anderson presents a numerical example in which the current tax treatment of cash value life insurance yields a real after-tax return approximately equal to that under an inflation-adjusted accretion-style income tax, on the assumption the inflation rate is 5.7 percent. Although Anderson claims the outcome is not all that sensitive to small changes in the inflation rate, his example would be more persuasive if it used a lower inflation rate, perhaps a rate in the 3.0 percent to 4.5 percent range, which is closer to what the U.S. has experienced in the last decade.

Public policy goals

Proponents of the "tax expenditures" concept do not argue that all "tax expenditures" be ended. What they declare, instead, is that every "tax expenditure" should be scrutinized to determine whether it meets worthwhile social policy goals and is the most effective way of doing so. If a "tax subsidy" fails either test, they say, then it should be eliminated. Of course, adopting this procedure would put the items listed on the "tax expenditures" budget at a major disadvantage. Opponents of a particular "tax expenditure" could readily attack it by claiming it to be unworthy, expensive, poorly targeted, or responsible for social problems that a direct government expenditure program could allegedly avoid. In the case of life insurance products, for example, the Treasury Report refuses to concede that there are any valid societal benefits from the current tax treatment of life insurance products, looks askance at the size of the "tax expenditure", and charges that the tax savings from current law are too concentrated among the wealthy.

One response is to observe that "tax expenditures" are computed with reference to a biased, inconsistent tax baseline. Provided the items in the "tax expenditures" budget are proper when measured against a tax benchmark that is closer to neutral, they do not need to be justified by appeal to special public policy goals.

Another approach, which Anderson also takes, is to challenge some of the Treasury Report's assertions. For example, he claims that life insurance products do furnish various social benefits. And he raises several issues that suggest the Treasury's cost estimate is on the high side.[63]

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[63] Anderson also asserts that a public subsidy would be justified because of the problem of adverse selection. Briefly, people expecting future health problems are more likely to want life insurance than people expecting to remain healthy. Because insurance companies have less accurate health information than policyholders, insurance companies have difficulty in adjusting policy prices to take these different health prospects into account. The upshot is that prices tend to be set too high for healthy people, deterring many of them from buying policies. Although this is true, it is not clear, contrary to what Anderson claims, that this, by itself, would justify a government

With regard to the criticism that the wealthy receive larger tax savings than the poor or middle class, he points out that although upper-income individuals hold a large share of life insurance policy assets, they hold a large share of most types of assets; that is a simple consequence of their relatively high incomes and wealth. But, as a share of their total assets, they keep a relatively small fraction in cash value life insurance. And, as people's wealth rises, the share of assets held in cash value life insurance falls more rapidly than for any other major asset class.[64] It is regrettable in this context that Anderson cannot just say that if current law is desirable on many fronts, it does not suddenly become undesirable if wealthy individuals happen to receive many of the direct benefits. Unfortunately, class warfare has become one of the most powerful weapons in public policy debates. There is often a knee-jerk assumption that it is automatically good to increase tax progressivity and automatically bad to decrease it. The radical income redistribution mentality that underlies this position is not supported by economic theory or by fact. The result of this mentality — if it prevails — is likely to be a complicated, arbitrary, discriminatory tax system that harms employment, production, and living standards and violates basic precepts of taxation.

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subsidy. (For example, the buyers of used cars typically have less information on the cars' true condition than do the sellers, but no one suggests that is a reason for the government to subsidize used car buyers.) It is much better to let the industry work to ameliorate adverse selection itself. Two methods the industry uses are medical exams and, as Anderson discusses, multi-year pricing. Unfortunately, the thrust of government policy is often to restrict efficient market pricing. For example, because women, on average, live longer than men, unisex life insurance premiums, which some state's have mandated, are not actuarially fair to women, discouraging some of them from buying policies, while unisex annuity premiums are not actuarially fair to men, causing some men to forego annuities. As another example in a different area of insurance, several states have sharply limited the degree to which health insurers can adjust premiums for expected differences in the costs of insuring different people. In New York state, this has produced soaring health insurance premiums for healthy individuals and led vast numbers of them to drop their insurance.

[64] See Anderson, *op. cit.*, p. 1429.

Conclusion

Life insurance products furnish significant benefits to both policyholders and the nation. For policyholders, they deliver payments in the future that are a major source of protection. For the nation, they are an important conduit in the channeling of saving into investment uses. Investment, of course, is one of the chief means by which people become more productive over time, hence, able to command higher real wages and enjoy rising living standards.

The proposals in the GAO and Treasury Reports would interfere with these functions by exposing many holders of cash value life insurance and annuity policies to current taxation on the returns earned within their polices prior to distribution. People would respond to these higher taxes by becoming less willing to own cash value life insurance and annuity policies. Although the two reports do not actually recommend that all policyholders be taxed on inside buildup on a current basis, they do mention that draconian tax change as an option Congress may wish to consider. And their recommendations, although less severe, are steps in that direction.

As the GAO and Treasury Reports admit, they have not attempted to estimate the harm their proposals would cause policyholders and the nation. Nor have the reports tried to delineate the benefits their recommended changes would supposedly bring. Instead, the reports claim the changes should be made because they are good tax policy (and, according to the reports, taxing all inside buildup on a current basis would be better tax policy). Ironically, that is the opposite of the truth. The reports embrace a definition of income that guarantees a bias against saving and investment, hence violate one of the basic principles of sound tax policy. The government's "tax expenditures" budget is also guilty of relying on a model tax that incorporates a powerful bias against saving. An alternative definition of income, which does not discriminate against saving and investment, reveals that the tax treatment of cash value life insurance and annuity policyholders is now close to correct, although in some cases policyholders are overtaxed.

Good tax policy directs that the current deferral rules on inside buildup should not be compromised. That is also consistent with allowing policyholders to protect themselves and minimizing government impediments to economic growth. If any changes are to be made, they should be in the direction of liberalizing the deferral rules and reducing or ending the tax on policy distributions.

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Objective economic analyses of the impact of government tax policies on the functioning of a free-market economy are essential for constructive public economic policies. Equally important are sound prescriptions of the kinds of policy changes that will reduce existing government obstacles to private saving and capital formation and to productive private efforts.

This report, by **IRET** Senior Economist Michael A. Schuyler and **IRET** President Norman B. Ture, examines key deficiencies in federal procedures for estimating how tax changes affect government revenue. Failings in current procedures, notably the insistence that tax changes do not affect the overall economy, systematically mislead policy makers, resulting in tax policies that may cost the American public hundreds of billions of dollars yearly. Correcting the deficiencies in the current estimating methodology is practical. And it is urgent.

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