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Report to the Chairman, Committee on Finance, U.S. Senate, and the Chairman, Committee on Ways and Means, House of Representatives

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TAX POLICY

Tax Treatment of Life Insurance and Annuity Accrued Interest

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

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

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

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

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

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