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Policyholders' Interest Income  
From Life Insurance Under the Income Tax  

Richard Goode*  

The author here examines the tax advantages to the individual saving through life insurance, considers the probable social and economic consequences of present and proposed tax treatment, and points out practical problems in attempting to tax interest income from life insurance policies. Dr. Goode concludes that the insurance investment enjoys a status which is untenable in light of acknowledged principles of tax equity, but sees difficulties in possible corrective measures.

Life insurance policies usually combine pure insurance and saving features. This fact is recognized by the industry and by those who draw up national economic accounts but is not fully reflected in the income tax. None of the return on saving through life insurance is taxed to a policyholder prior to the maturity, redemption, or surrender of a policy. Part of the return, but apparently only a small fraction of the total, is taxed when policies mature for reasons other than the death of the insured or are redeemed or surrendered.

Inasmuch as most forms of investment income are taxable, the present law discriminates in favor of saving through life insurance compared with other forms of saving and financial investment. This discrimination prompts questions of equity and economic policy. Is it fair to impose lower income taxes on those who are eligible for life insurance and who choose to save in this form than on others? Does the preferential income tax status of saving through life insurance induce a shift of resources from other fields, and if so what are the consequences for economic efficiency and growth?

There have been occasional suggestions that policyholders' interest income be taxed, notably by Vickrey and Pechman.1 Most discussions of life insurance taxation, however, relate to the treatment of insur-

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*Senior Staff Member, The Brookings Institution. I wish to acknowledge with thanks the helpful comments and suggestions of Roy E. Moor and the assistance of M. Leon Askren and Sunder Dass. Opinions and interpretations are my own and do not necessarily reflect their views or the views of officers or other staff members of the Brookings Institution.

lace companies rather than policyholders. It has not even been generally recognized that an income tax problem exists with respect to policyholders.

This paper examines the nature and quantitative importance of the tax discrimination in favor of individual saving through life insurance, considers the probable economic and social consequences of the present and alternative tax treatments, and reviews practical problems that would be encountered in an effort to tax interest income of life insurance policyholders. Incidental comments are made on the taxation of life insurance companies. No attention is given to certain important matters including, on the theoretical level, the justification for the exclusion of death benefits from the taxable income of beneficiaries and, within the framework of existing law, possibilities of tax avoidance by borrowing to pay insurance premiums and the provision of nontaxable compensation for employees in the form of life insurance coverage. For simplicity, it is assumed, unless otherwise stated, that the insured is the policyholder—that is, that the person on whose life an insurance policy is issued is also the owner of the policy.

Readers are warned that they will not find in this paper clear-cut solutions of all the conceptual and practical problems that would be associated with the taxation of policyholders' interest income from life insurance or a set of positive recommendations for modifying the present law.

I. Policyholders' Interest Income and Its Present Tax Status

A. Nature of Interest Income from Life Insurance

The nature of the interest income received by a policyholder can be illustrated by the most popular form of individual life insurance contract, a level premium whole life policy. Under this policy a constant amount of premium is paid each year, and the policy matures at the death of the insured. The contract is called an ordinary life insurance policy (or a straight life insurance policy) if premium payments are required throughout the lifetime of the insured; it is a limited payment policy if premiums end after a stated number of years or at a specified age, say 65 or older. Both kinds of policies involve important saving elements.

In the earlier years of the contract, the annual payment under a level premium policy is much greater than the current cost of insurance, which is the amount that must be paid to cover the risk that the policyholder will die during the year. The excess premium payment is placed in a "reserve" and invested by the company. Earnings on the reserve are used to pay future costs and benefits. At the death of the insured, the company liquidates the reserve and con-
tributes any remaining part of the face value of the policy out of its current receipts from other policyholders or its surplus funds. A level premium policy of $1,000 does not provide insurance of $1,000 but only of $1,000 less the policyholder’s own accumulated excess payments. As one writer puts it, “The plan is not pure insurance but a combination of a decreasing insurance with an increasing investment, the two amounts being computed mathematically in such a way that in any year their sum is equal to the face amount payable under the policy.”

Table 1 shows for successive five-year periods the relevant figures for a $1,000 ordinary life insurance policy issued at age 45. The annual net premium is $29.98, payable throughout life. The net premium makes no allowance for operating and other expenses of the company; adding a charge for this is called “loading.” The gross premium paid by a policyholder is larger than the net premium, but

<table>
<thead>
<tr>
<th>Age</th>
<th>Net Premium</th>
<th>Cost of Insurance</th>
<th>Interest Earned</th>
<th>Terminal Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-49</td>
<td>$149.90</td>
<td>$46.32</td>
<td>$9.36</td>
<td>$112.93</td>
</tr>
<tr>
<td>50-54</td>
<td>149.90</td>
<td>58.64</td>
<td>23.60</td>
<td>227.77</td>
</tr>
<tr>
<td>55-59</td>
<td>149.90</td>
<td>74.00</td>
<td>37.94</td>
<td>341.58</td>
</tr>
<tr>
<td>60-64</td>
<td>149.90</td>
<td>92.37</td>
<td>51.98</td>
<td>451.07</td>
</tr>
<tr>
<td>65-69</td>
<td>149.90</td>
<td>113.38</td>
<td>65.31</td>
<td>552.88</td>
</tr>
<tr>
<td>70-74</td>
<td>149.90</td>
<td>136.20</td>
<td>77.54</td>
<td>644.10</td>
</tr>
<tr>
<td>75-79</td>
<td>149.90</td>
<td>159.99</td>
<td>88.32</td>
<td>722.60</td>
</tr>
<tr>
<td>80-84</td>
<td>149.90</td>
<td>182.46</td>
<td>97.45</td>
<td>787.48</td>
</tr>
<tr>
<td>85-89</td>
<td>149.90</td>
<td>202.73</td>
<td>104.90</td>
<td>839.48</td>
</tr>
<tr>
<td>90-94</td>
<td>149.90</td>
<td>213.59</td>
<td>110.96</td>
<td>886.73</td>
</tr>
<tr>
<td>95-99</td>
<td>149.90</td>
<td>153.56</td>
<td>118.26</td>
<td>1,000.00</td>
</tr>
<tr>
<td>45-99</td>
<td>$1,648.90</td>
<td>$1,432.99</td>
<td>$785.62</td>
<td>$1,000.00</td>
</tr>
</tbody>
</table>

a At beginning of insurance year.
b At end of period; applies to age one year greater than second figure shown in stub.

3. This and other illustrations are based on the Commissioners 1941 Standard Ordinary Mortality Table, the most commonly used table, and an assumed interest rate of 21/2%. Writing in 1959, Dan M. McGill stated that the 21/2% interest assumption was “perhaps representative of the rate used by most companies” for new life insurance contracts, although many companies used 21/2% and a few 2% and many old contracts provided for substantially higher rates. McGill, Life Insurance 175-76 (1959).
since the loading factor varies among companies it is simpler to deal with the net premium. Savings accrue because the net premium exceeds the cost of insurance up to age 75. Interest is earned on the accumulated excess premiums and is compounded. Accumulated savings, representing net premiums and interest in excess of current insurance costs, are reflected in the terminal reserve. The net amount of insurance protection afforded by the policy is $1,000 minus the terminal reserve (shown for each fifth year in the last column). In the third five-year period, for example, net premiums exceed the cost of insurance by $75.90, while interest earned on accumulated savings totals $37.94. The terminal reserve increases by $113.81, which (with allowance for rounding of digits) is equal to the sum of these two items. After age 74 the reserve increases by less than interest earned inasmuch as the current premium is not sufficient to cover the full cost of insurance.\footnote{For any year, the cost of insurance is q(F - R_2), the interest earned is i(R_1 + P), and the increase in the reserve is P + i(R_1 + P) - q(F - R_2), where q is the probability of dying, F is the face amount of the policy, R_2 is the reserve at the end of the current year, R_1 is the reserve at the end of the prior year, P is the annual net premium, and i is the interest rate.}

The saving and interest features are more prominent in limited payment policies than in ordinary life policies. By paying a higher premium for a shorter period, the insured builds up savings more rapidly and earns more interest. At the extreme, all premiums are paid in a lump sum and the policy (called a single premium policy) provides a means of investing previously accumulated savings so that interest earnings are sufficient to cover annual insurance costs and add to the reserve fund. The limited payment policies offer less insurance protection than an ordinary life policy because policyholders pay more premiums and their own funds accumulate more rapidly. Three policies for $1,000 issued at age 45 provide the following illustrative figures for the first 26 years (which takes the policyholder to the end of his life expectancy of 70+)

<table>
<thead>
<tr>
<th></th>
<th>Total Net Premiums</th>
<th>Total Interest Earned</th>
<th>Terminal Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary life</td>
<td>$779</td>
<td>$203</td>
<td>$572</td>
</tr>
<tr>
<td>20-payment life</td>
<td>727</td>
<td>301</td>
<td>808</td>
</tr>
<tr>
<td>Single premium life</td>
<td>551</td>
<td>441</td>
<td>808</td>
</tr>
</tbody>
</table>

Endowment insurance policies, which mature after a fixed number of years or at the death of the insured if that occurs earlier, involve the largest saving and investment elements.

Term insurance policies, in contrast to whole life policies and endowment insurance, involve little saving and interest earnings.
one-year term policy includes no saving feature, the net premium being paid entirely for current insurance protection. The contract in this respect resembles a typical fire insurance policy or other casualty insurance contract. A small saving element may be introduced in a term policy running for several years. Term insurance has been gaining in popularity, particularly in the form of group insurance.

The interest earned on a policyholder's savings in the form of life insurance reserves ultimately may be paid to beneficiaries as part of death benefits or to the insured during his lifetime when a whole life policy is surrendered or an endowment insurance policy matures, or it may be used to cover the cost of insurance during certain periods of the insured person's life.

The insured has ready access to his savings accumulated with a life insurance company. He can realize on the savings prior to the maturity of the policy by surrendering it for a cash settlement or by converting it to a paid-up policy or an extended term insurance policy. He can also use the savings as collateral for a loan. Under state laws, minimum surrender values are somewhat less than policy reserves, but companies often offer surrender values in excess of the legal minimum.

Under a participating policy, adjustments of costs are made by distribution of surplus earnings through the payment of dividends. Surplus earnings arise if mortality rates are lower than assumed, interest earnings are higher than assumed, or expenses are lower than assumed. Nonparticipating policies do not provide for dividends. Most stock insurance companies issue chiefly nonparticipating policies whereas mutual companies generally issue only participating policies. Stock companies are more numerous than mutual companies but on the average are smaller. At the end of 1960, 67 per cent of all life insurance in force with legal reserve companies in the United States was on a participating basis.5

B. Present Tax Treatment

The present federal income tax law provides that amounts received under a life insurance contract and paid by reason of the death of the insured shall be excluded from taxable income of the insured and the beneficiary, regardless of whether paid in a lump sum or otherwise.6 No distinction is made between interest earned on the insured's savings accumulated under the contract and the remainder of the proceeds.

When the proceeds of a life insurance contract are paid after the

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5. INSTITUTE OF LIFE INSURANCE, 1961 LIFE INSURANCE FACT BOOK 14 [hereinafter cited as LIFE INSURANCE FACT BOOK].
death of the insured, as for example in installments over a period of years, interest earned after the death of the insured is taxable to the beneficiary, but the part of the proceeds representing interest earned prior to the death of the insured is not taxable.\(^7\) In determining the amount of interest that is taxable, the lump-sum amount that would have been available at the death of the insured, or its equivalent, is prorated over the period of payment and only the amount received in excess of this prorated cost is taxable as interest income. When payments take the form of a life annuity to the beneficiary, the proration is made on the basis of the mortality table used by the insurance company in determining the benefits.\(^8\) A surviving spouse is entitled to exclude up to $1,000 per annum of interest income from life insurance proceeds held by the company after the death of the insured.\(^9\)

When the proceeds of a life insurance contract are paid for reasons other than the death of the insured (on account of surrender, redemption, or maturity), the proceeds in excess of the cost of the contract are taxable.\(^10\) If the proceeds are received in a lump sum, the total cost is excludable in the year of receipt and the amount to be included in taxable income is the total proceeds minus the total cost. On lump-sum proceeds, the tax may be computed as if they had been received in equal installments over a three-year period. The taxpayer's cost is defined as the aggregate premiums paid, or other consideration, less any amount already received as dividends or in some other tax-free form.

Owing to the liberality of the rule for determining the cost of a life insurance contract, the income tax reaches only a part of the interest earned with respect to policies the proceeds of which are paid for reasons other than death. The rule takes no account of the fact that the premiums paid while the contract was in force were partly for the purpose of covering current insurance costs due to the risk of death during that period. The effect of the rule is to include interest earnings in taxable income only to the extent that they exceed the cost of the protection enjoyed by the insured. The point may be illustrated by reference to the three policies mentioned on page 36. On the assumption that the cash surrender values of the policies at the end of the period are equal to the terminal reserves, the amount included in taxable income if a policy were surrendered would be substantially less than the total interest earned. A first approximation of the amount to be included in taxable income is the excess, if any, of the terminal reserve (approximate surrender value) over total net premiums. The

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\(^7\) INT. REV. CODE OF 1954, § 101(d).
\(^8\) Treas. Reg. § 1.101-4 (1957).
\(^9\) INT. REV. CODE OF 1954, § 101(d).
\(^10\) INT. REV. CODE OF 1954 § 72(e).
actual amount probably would be smaller because the cost of the contract would be measured by total gross premiums, which exceed net premiums by the loading factor.\(^{11}\) For participating policies, the gross cost would be reduced by the amount of any nontaxable dividends previously received.

C. Taxation of Life Insurance Companies

The favorable tax treatment enjoyed by life insurance policyholders is not offset by special federal taxation of the insurance companies. Life insurance companies have been more lightly taxed than most other corporations under the federal income tax. A revision of the federal income tax on life insurance companies was adopted in 1959, applicable to 1958 and later years. This revision increased income tax liabilities by subjecting to tax not only the so-called free investment income of the companies (that is, investment income in excess of that required to be added to policy reserves), but also a portion of underwriting gains. Although there are differences of opinion about the wisdom of the 1959 legislation, it seems that most critics do not assert that federal income taxes are now heavier on life insurance companies than on other corporations, but rather maintain that there are valid reasons for lower income taxes on life insurance companies. The arguments pro and con will not be examined here.\(^ {12}\)

II. Quantitative Importance of Life Insurance Reserves and Interest Income from Them

A. Total Amount of Reserves and Interest Income

In 1957, policy reserves for life insurance in force in the United States with private companies averaged approximately $54 billion, and estimated interest earnings on these reserves amounted to $1.9

11. Referring to a similar provision of prior law, Richard S. Brawerman said that the statute "permits the insured to recoup amounts spent for loading and insurance protection, which are personal expenses, out of interest credited to the reserve, which is income." He also pointed out that the provision favored whole life insurance over term insurance inasmuch as "The insured [under a term policy] must pay for insurance protection and loading, which are not deductible, almost entirely out of other income which is taxable." Brawerman, How Can We Avoid a Tax on the Income From a Life Insurance Policy?, 6 J. Am. Soc'y C.L.U. 376 (1952).

billion (Table 2). The figure for reserves relates to life insurance strictly defined. It excludes reserves for insured pension funds and annuities and health insurance, which are often included in life insurance company statistics. The reserve figure is adjusted to exclude estimated reserves on foreign business of United States companies and to include estimated reserves on United States business of foreign (mostly Canadian) companies. In estimating the interest earned on policy reserves it is assumed that the rate of return on reserves was

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Policy Reserves a</th>
<th>Net Rate of Interest Earned b</th>
<th>Estimated Interest Earned on Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>$37.3</td>
<td>3.00%</td>
<td>$1.1</td>
</tr>
<tr>
<td>1951</td>
<td>39.3</td>
<td>2.98%</td>
<td>1.2</td>
</tr>
<tr>
<td>1952</td>
<td>41.5</td>
<td>3.07%</td>
<td>1.3</td>
</tr>
<tr>
<td>1953</td>
<td>44.0</td>
<td>3.15%</td>
<td>1.4</td>
</tr>
<tr>
<td>1954</td>
<td>46.5</td>
<td>3.24%</td>
<td>1.5</td>
</tr>
<tr>
<td>1955</td>
<td>49.1</td>
<td>3.23%</td>
<td>1.6</td>
</tr>
<tr>
<td>1956</td>
<td>51.8</td>
<td>3.33%</td>
<td>1.7</td>
</tr>
<tr>
<td>1957</td>
<td>54.4</td>
<td>3.46%</td>
<td>1.9</td>
</tr>
<tr>
<td>1958</td>
<td>56.9</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1959</td>
<td>59.9</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1960</td>
<td>63.1</td>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
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<td>54.4</td>
<td>3.46%</td>
<td>1.9</td>
</tr>
<tr>
<td>1958</td>
<td>56.9</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1959</td>
<td>59.9</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1960</td>
<td>63.1</td>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>

* Average for beginning and end of year; excludes reserves for health insurance, individual policy pension trusts, and other insured pension plans. Reserves for life insurance in force in the United States were estimated by multiplying the figures for aggregate policy reserves of U.S. companies by the annual ratios of life insurance in force in the United States to life insurance in force with U.S. companies, including in the calculations both ordinary life insurance and industrial life insurance.

* Net rate of interest earned on invested funds after federal income taxes, U.S. life insurance companies.

Source: Estimates derived from Institute of Life Insurance, Life Insurance Fact Book and Tally of Life Insurance Statistics and additional data supplied by the Institute of Life Insurance.

equal to the net rate of return, after federal income tax, earned on all invested funds by United States life insurance companies.

Life insurance policy reserves continued their growth after 1957, but information is not available on the net rate of return earned by the insurance companies in recent years. The rate of return before federal income tax increased in 1958-60, but federal income tax liabilities were greater in relation to income than in prior years because
of the legislation enacted in 1959. Without attempting a precise estimate, earnings on policy reserves may be placed at roughly $2 billion in recent years.

Earnings on policy reserves are provisionally taken as the measure of policyholders' income from their savings in the form of life insurance. Arguments can be made for two alternative methods of estimation, one of which would raise the income figure and the other of which would lower it. The first alternative is to impute to policyholders not only the earnings on policy reserves but also earnings on the companies' accumulated surplus, of which approximately $3.9 billion may be attributed to life insurance in 1957. This approach would yield an estimate of policyholders' interest income in 1957 and other recent years about $0.1 billion higher than the first estimate. It is followed in the national income accounts of the Department of Commerce and in the well-known estimates of individual saving prepared by the Securities and Exchange Commission and Raymond W. Goldsmith, but not in the estimates derived from the Federal Reserve flow of funds accounts. In a mutual company the surplus theoretically belongs to the policyholders, but in practice the policyholders can realize their shares of the surplus only through dividends or on the liquidation of the company. The usual view in the industry has been that each policy or group of policies should make a permanent contribution to the surplus of the company and that no effort should be made to distribute to each class of policies the full amount of its contribution to earned surplus. Policyholders in stock companies have no direct claim on earned surplus although these resources provide an additional margin of security for the policyholders. I consider it more conservative to attribute to policyholders only the earnings on policy reserves rather than the earnings on reserves plus accumulated surplus.

The second alternative method of estimating policyholders' income from life insurance savings is to make the imputation at the assumed interest rate rather than the interest rate actually earned by the companies on their investments. (The assumed rate of interest is

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14. Total unassigned surplus was approximately $5.6 billion in 1957. 1957 Life Insurance Fact Book 55; 1958 Life Insurance Fact Book 63. In arriving at the figure in the text this sum was divided between life insurance and other contracts in proportion to the total reserves for the different kinds of contract. Both surplus and reserves for 1957 were taken as the average of figures for the beginning and end of year.
15. Huebner & Black, Life Insurance 244 (5th ed. 1958); McGill, op. cit. supra note 3, at 251, 303, 353. Some companies return a portion of surplus in the form of settlement dividends.
the guaranteed rate on the basis of which premiums, reserves, and benefits are computed.) In 1957 the average assumed rate of private companies was approximately 2.8 per cent.\textsuperscript{17} Calculated on this basis, policyholders' interest income from private life insurance amounted to about $1.5 billion in 1957 rather than the $1.9 billion shown in Table 2. The choice of the appropriate interest rate is considered in a later section.

In order to obtain a comprehensive estimate, it is necessary to add an allowance for government life insurance, with policy reserves of approximately $3 billion in 1957 and earnings on these reserves of $0.1 billion.\textsuperscript{18} The total of policyholders' interest earnings from both private and government life insurance in 1957 amounted to between $1.6 billion and $2.0 billion.

B. DISTRIBUTION BY INCOME CLASSES

Little information is available on the distribution of reserves by income of the policyholders. Among the few estimates are those of Goldsmith showing policy reserves for early 1950 distributed according to 1949 income. Goldsmith's estimates show that life insurance reserves were somewhat more heavily concentrated in upper income classes than was money income, but his statistics do not provide details for very high income classes. According to his estimates, those with money incomes of less than $4,000 in 1949 received 46 per cent of all money income and owned only 39 per cent of life insurance policy reserves; those with incomes in excess of $7,500 received 20 per cent of total income and owned 25 per cent of life insurance reserves (Table 3).\textsuperscript{19} Goldsmith's estimates indicate a high correlation between amount of life insurance policy reserves owned and age of the family head. Families headed by young persons owned a fraction of life insurance policy reserves that was much smaller than the fraction of income received by these families.\textsuperscript{20}

\textsuperscript{17} Averages of 2.980\% for stock companies and 2.725\% for mutual companies, combined with weights of 37\% and 63\%, respectively, which are the proportions of total life insurance with the two classes of companies at the end of 1957. \textit{1958 Life Insurance Fact Book} 15; \textit{Hearings on Tax Formula for Life Insurance Before the Senate Finance Committee}, 86th Cong., 1st Sess. 185 (1959) [hereinafter cited as \textit{1959 Hearings}].

\textsuperscript{18} This includes reserves for the United States Government Life Insurance Fund, National Service Life Insurance, and Veterans Special Term Insurance Fund. The aggregate of these reserves was $2.98 billion on June 30, 1957; the average for that date, June 30, 1956, and June 30, 1958 was $2.91 billion, 1956, 1957, 1958 \textit{Ann. Rep. of Veterans Affairs}. The average rate of interest, assumed and earned, was 3.17\% in fiscal year 1956-57 and 3.15\% in fiscal year 1957-58, 1957 \textit{Sec. of Treas. Ann. Rep. 414}; 1958 \textit{Sec. of Treas. Ann. Rep. 476}. The earnings are net of administrative costs, which are borne by the government.

\textsuperscript{19} 3 Goldsmith, \textit{A Study of Saving in the United States} 126 (1956).

\textsuperscript{20} Id. at 128.
Table 3. Distribution of Money Income and Life Insurance Policy Reserves by Money Income Classes, 1949 and 1957

<table>
<thead>
<tr>
<th>Money Income</th>
<th>1949 a</th>
<th>1957 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $1,000</td>
<td>2 4</td>
<td>1 6</td>
</tr>
<tr>
<td>$1,000-1,999</td>
<td>9 6</td>
<td>4 3</td>
</tr>
<tr>
<td>2,000-2,999</td>
<td>19 16</td>
<td>9 7</td>
</tr>
<tr>
<td>3,000-3,999</td>
<td>15 14</td>
<td>11 10</td>
</tr>
<tr>
<td>4,000-4,999</td>
<td>19 21</td>
<td>28 24</td>
</tr>
<tr>
<td>5,000-7,499</td>
<td>20 25</td>
<td>17 19</td>
</tr>
<tr>
<td>7,500-9,999</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10,000 and over</td>
<td></td>
<td>25 30</td>
</tr>
<tr>
<td>Not ascertained</td>
<td>-- 1</td>
<td>-- 1</td>
</tr>
</tbody>
</table>

a Policy reserves in early 1950; money income in 1949.

Sources: 1949, 3 Goldsmith, A STUDY OF SAVING IN THE UNITED STATES 126 (1956); 1957, income distribution from Survey of Consumer Finances, 45 Fed. Reserve Bull. 713 (1959); life insurance reserves assumed to be distributed in the same relation to income as in 1949.

I have not been able to develop independent estimates of the distribution of policy reserves among income groups but have extended Goldsmith’s estimates to later years on the assumption that the relation between the cumulative distributions of income and life insurance policy reserves was the same as that estimated by Goldsmith for 1949.21 My estimates for 1957 are shown in Table 3.

C. Revenue Implications

A change in the Internal Revenue Code requiring policyholders to include the imputed interest on policy reserves in their taxable income would increase the individual income tax base by less than the full amount of net interest earned on the reserves for life insurance in force in the United States. Part of the interest income is already taxable to policyholders, or beneficiaries; and presumably, provision would be made to avoid taxing this part of the income twice under the individual income tax. Furthermore, some policyholders have

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21. With consumer units ranked by income, Goldsmith’s estimates show that those below a certain level received x % of income and owned y % of life insurance reserves in 1949. I assumed that units accounting for the first x % of income in a later year likewise owned y % of policy reserves. Because of the general rise in income, the money income level below which x % and y % fall is higher in recent years than in 1949. I obtained percentage figures for reserves for money income classes by graphic interpolation.
incomes below the amount of their personal exemptions and deductions.

Although statistics are not available to allow an accurate estimate, it seems unlikely that a large fraction of the interest earned on policy reserves is taxable to individuals at the present time, in view of the liberality of the existing rules. The interest component of death benefits is exempt in all cases. These benefits in 1957 represented one-half of all life insurance benefits other than policy dividends. Another one-fourth of the benefits in that year consisted of surrender values; and as previously explained, these result in taxable income only to the extent that they exceed aggregate gross premiums without adjustment for the cost of protection during the period in which the policy was in force. The remaining one-quarter of the benefits—representing matured endowments, annuities, and disability benefits—may well include a proportionately greater element of taxable interest income, but it would be surprising if the taxable component were large even for these benefits.

The estimates presented in Table 3 suggest that most of the policy reserves in 1957 were attributable to persons who were subject to the individual income tax. Perhaps a reasonable assumption is that the fraction attributable to nontaxable individuals is approximately equal to the 9 per cent assigned to consumer units with money incomes below $3,000. On this assumption, the gross addition to taxable income due to the taxation of interest earned on life insurance reserves in 1957 would have been about $1.5 billion to $1.8 billion. The net addition would be smaller by the unknown (but probably minor) amount of interest income from life insurance reserves now taxable to individuals.

On the further assumption that the tax rate applicable to the additional income would have been approximately equal to the average rate on all taxable income in 1957 (23 per cent), the gross increase in individual income tax yield would have been some $0.3 billion to $0.4 billion in 1957. This is a rough estimate, but would not be greatly different if based on alternative reasonable assumptions.

22. 1961 LIFE INSURANCE FACT BOOK 38.
23. These figures represent 91% of $1.6 billion or of $2.0 billion respectively. The lower figure reflects imputation at the average assumed rate of interest, and the higher figure imputation at the average rate of return earned on investments by life insurance companies. Both totals include interest on government life insurance reserves.
24. UNITED STATES OFFICE OF INTERNAL REVENUE, STATISTICS OF INCOME 3 (1957).
III. Economic and Social Consequences of Present Tax Treatment

The preferential tax treatment that is now accorded interest earned on life insurance policy reserves makes possible a larger net yield on individuals' saving through life insurance than could be obtained if this interest were taxed in the same way as other investment income. Presumably, the result is that the attractiveness of life insurance is enhanced relative to other investments and the share of individual saving that goes into life insurance is increased.

An appraisal of the influence of the preferential tax treatment is complicated by the fact that individuals can take advantage of the tax shelter only in conjunction with the purchase of life insurance. The saver, therefore, must incur costs for insurance protection and must bear the loading charges that are assigned to his particular class of policy. This may not be a serious disadvantage from the point of view of those who desire life insurance for its own sake, but for others it may be an offset to the tax advantages.

The present tax treatment of saving through life insurance is especially advantageous to persons with large incomes and high marginal tax rates. This feature is recognized by writers on insurance and must be known to high-income individuals and their financial advisers. Wealthy persons, however, are likely to be less interested in life insurance protection than persons who depend mainly on earned income. Among investors, moreover, the management skill and guaranteed minimum return associated with a life insurance policy are likely to be more attractive to persons of moderate means than to those with large resources. For those in high tax brackets, municipal bonds offer tax exemption without the necessity of paying for life insurance company services. Up to 1957 the net interest rate earned by life insurance companies was higher than the yield of high-grade tax-exempt securities, by a wide margin in the early postwar years. In 1957, the market yield of high-grade tax-exempt securities surpassed the average net return on life insurance company investments, and this may well have also been true in 1958-61.

These speculations appear to be consistent with Lampman's findings. His estimates for 1953 indicate that equities in life insurance reserves were only 2 per cent of the gross estate of top wealth-holders (those with wealth of $60,000 or more) compared with 6 per cent of the gross estate of all persons. State and local bonds, corporate stock, and United States government bonds, on the other hand, were rela-

26. See, e.g., Life Insurance—Your Best Investment (Hill ed.).

27. Compare Table 2 with the average yield of high-grade municipal bonds included in Standard & Poor's index (1962 Economic Report of the President 293).
tively more important in the estates of top wealth-holders than in all estates. Among top wealth-holders, life insurance increased in relative importance up to the gross estate class $150,000 to $200,000 and diminished rapidly in relative importance in higher estate classes.28

It is plausible to suppose that the favored tax treatment of the interest return on life insurance savings has its greatest influence on the decisions of persons in the upper middle income groups, particularly those who depend mainly on salaries or professional fees. Tax considerations are less compelling for these groups than for those in the highest brackets, but they are significant and are coming to be widely recognized. Even those who do not explicitly calculate the tax advantages of life insurance may be attracted by the benefits which are possible in part because of the tax-free reinvestment and compounding of interest and the opportunity of passing on to heirs the accumulated interest without payment of an income tax.

An increase in life insurance saving which is induced by its special tax status may be reflected in larger sales of insurance policies and in a shift toward policies with greater saving elements—endowment and limited-payment policies as distinguished from ordinary life policies and term policies. The increase in saving through life insurance may represent in part a net addition to individual saving but is likely to reflect mainly a reallocation of saving among alternative outlets.

The increase in life insurance reserves has long represented a significant portion of total personal saving. According to Goldsmith's estimates, saving through private life insurance equalled a considerably greater fraction of total personal saving in the period 1946-56 than in the 1920's or in the two decades 1900-1919 (Table 4).29 The postwar fraction, however, is far below that of the 1930's. During the 1930's, saving through life insurance increased compared with the 1920's, whereas total personal saving decreased sharply. The small relative importance of life insurance saving in the period 1940-45 is due mainly to the large increase in liquid assets in wartime.

The increased importance of life insurance saving in the postwar years compared with the 1920's is consistent with the hypothesis that the income tax was a factor encouraging this form of saving. Income tax rates were much higher in the postwar period than in the 1920's, and the tax advantages of life insurance saving were correspondingly greater. Many other influences were at work, however, and the statistics should not be interpreted as affirmative evidence of a tax-

29. Goldsmith’s estimates of saving through private life insurance companies were adjusted to exclude the increase in reserves for insured pension plans in the period 1930-56. See footnote to Table 4, in text at p. 47.
Table 4. Personal Saving Through Private Life Insurance in Relation to Total Net Personal Saving, Selected Periods 1900-56

<table>
<thead>
<tr>
<th>Period</th>
<th>As Percentage of Total Net Personal Saving</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Including Consumer Durables</td>
</tr>
<tr>
<td>1900-09</td>
<td>7.5</td>
</tr>
<tr>
<td>1910-19</td>
<td>5.3</td>
</tr>
<tr>
<td>1920-29</td>
<td>11.3</td>
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<tr>
<td>1930-39</td>
<td>43.0</td>
</tr>
<tr>
<td>1940-45</td>
<td>8.7</td>
</tr>
<tr>
<td>1946-56b</td>
<td>13.2</td>
</tr>
</tbody>
</table>

*a* Derived from estimates of Raymond W. Goldsmith published in U.S. Bureau of the Census, Historical Statistics of the United States, Colonial Times to 1957 156 (1957). For 1930-56, Goldsmith’s estimates of personal saving through private life insurance were adjusted to exclude the increase in reserves for insured pension plans in force with U.S. life insurance companies, on the basis of data from Life Insurance Fact Book, 1961 36, 37, and Board of Governors of the Federal Reserve System, Flow of Funds/Saving Accounts, 1946-1960 83 (Supp. 5 Dec. 1961). Reserves for such pension plans, estimated at $0.1 billion in 1930, are believed to have been of minor importance prior to that time. Total personal saving is net of the increase in debt and accrued tax liabilities and net of depreciation at replacement cost.

*b* Estimates of total personal saving in 1946-56 are not fully comparable with those for earlier years.

...induced change in saving patterns.

If the present tax treatment induces a shift of saving toward life insurance companies, this may have a tendency to increase the proportion of total saving going into fixed claims compared with equities. Life insurance companies place most of their gross investment in debt instruments (Table 5). This pattern is readily explained by the nature of insurance contracts and the traditions of the industry, reinforced by government regulation. Equities account for a much larger fraction of the gross investment of consumers and nonprofit organizations. (Separate data are not available for individuals and nonprofit organizations.) Individuals, however, may not regard life insurance as a close substitute for houses, consumer durables, and investment in noncorporate businesses, but as an alternative to direct financial investment. Among individuals’ financial investments, other than life insurance and pension funds, fixed claims have been of preponderant importance in the postwar period (Table 5). Life insurance company investments in mortgages, moreover, helped finance individual’s equity investments in houses, which, aside from consumer durables, were by far the largest equity investment of individuals. It is not clear that a change in the proportion of saving channeled through life insurance companies would have a great in-
The individualist tradition attaches importance to a policy of encouraging persons to make adequate provision for the care of their dependents. Life insurance is a well-established means of doing so in certain circumstances and appears to enjoy wide social approval. To say, however, that life insurance discharges socially useful functions does not establish a case for the present tax treatment. The tax shelter available for interest earned on policy reserves is not so much a general subsidy for life insurance as a special preference for in-
insurance contracts involving large saving elements. Persons who carry term insurance receive little benefit from this provision. Certain other forms of saving which perform essentially the same social function as investment in life insurance policies do not enjoy equally favorable tax treatment.

The tax laws of certain other countries also extend special treatment to life insurance. In the United Kingdom, for example, a limited deduction from taxable income is allowed for life insurance premiums, and the taxation of benefits seems to be somewhat more liberal than in the United States.30 On the other hand, it appears that life insurance companies are more severely taxed on their investment income in the United Kingdom than in the United States.31 In Sweden, life insurance premium payments may qualify as part of a “social deduction,” which also includes compulsory contributions to health insurance, and premiums for unemployment, sickness, and accident insurance; but the maximum amount of the social deduction is small.32

An important characteristic of life insurance is the long duration of contracts. This makes it difficult to change the income tax treatment of life insurance without upsetting financial plans that are important to many families. There would doubtless be strong objection to a tax revision that made it difficult or impossible to consummate insurance programs already adopted by policyholders.

In view of the complexity of life insurance, problems of tax design are peculiarly important in assessing the feasibility and desirability of attempting to include policyholders’ interest income in the base of the individual tax. These problems will now be examined.

IV. PRACTICAL PROBLEMS IN TAXING INTEREST ON LIFE INSURANCE SAVINGS

Taxation of policyholders on their interest income from life insurance savings would involve complex problems of income measurement as well as difficulties of compliance and administration. Problems of income measurement and of tax collection are considered

30. The deduction for premium payments is for purposes of determining income subject to the standard tax and is not allowed for surtax purposes. The deduction is 3% of the amount of the premium but not to exceed 3% of the taxpayer’s total income or 7% of the death benefit. Lump-sum proceeds paid to the insured or his beneficiary are not taxable, whereas periodic payments to annuitants are divided into a non-taxable element and a taxable element according to a rule that seems to be similar to that prescribed by the United States statute and regulations. See Harvard University, International Program of Taxation in the United Kingdom 260, 263, 367 (1957).

31. The usual method in the United Kingdom is to tax the companies on their entire investment income less management expenses, but without deduction of amounts added to policy reserves; apparently underwriting profits escape taxation under this method. Id. at 300-02.

below, and the possibility of approximating the results of individual taxation by means of an additional tax on life insurance companies is examined. No attention is given to possible constitutional issues relating to the taxation of imputed income.

A. INCOME MEASUREMENT

The approach under consideration would involve the annual imputation to each life insurance policyholder of an amount of income equal to the return on the accumulated savings properly assignable to his policy. This imputed income would be annually includible in the adjusted gross income of the policyholder for tax purposes. The policyholder is the owner of the policy. Ordinarily he is the person on whose life the policy was issued, but when this is not the case the owner of the policy, rather than the *cestui que vie*, would be the person who would be taxable. Any imputed interest which had been included in the adjusted gross income of a policyholder would be considered part of the cost of the contract; and if it were later received by the policyholder by virtue of the maturity or surrender of the policy, it would not be includible in adjusted gross income at that time. Dividends received on participating policies would not be includible in income but, as at present, would be considered an adjustment of the gross premium. I shall assume, moreover, that the present exclusion of amounts received by reason of the death of the insured would continue.

For reasons stated in a preceding section, policy reserves seem to be the best measure of policyholders' accumulated savings. Consideration might be given, however, to cash surrender values as an alternative measure. Although there is no theoretical case for this expedient, it might be justified in the interest of simplicity. Surrender values are usually smaller than policy reserves, but the difference is not great after a policy has been outstanding for a number of years. Minimum cash surrender values are established by the Standard Nonforfeiture Law, which is in effect in most of the states. The minimum cash value is approximately equal to the policy reserve less the part of certain special initial expenses which has not yet been amortized. Many companies provide more liberal surrender values. The advantage of using surrender value as a measure of policyholders' accumulated savings would be that these values are often printed on the policy and are therefore more readily ascertainable and understandable to policyholders than the reserve figure is. Participating policies, however, commonly allow dividends to be used

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33. Under the Standard Nonforfeiture Law, minimum surrender values are derived independently of policy reserves, but the result is substantially that stated in the text. See McGill, op. cit. supra note 3, at 295-308.
to purchase additional insurance; and when this option is elected, the surrender value exceeds the basic amount shown on the policy. In such cases the individual policyholder could not be expected to know the cash surrender value of his policy.

The choice of the appropriate interest rate for computing the amount of imputed income would present no difficulty in the case of nonparticipating policies. For these policies, the assumed rate would be the proper one since this is a contractual rate which cannot be exceeded.

For participating policies, which represent more than two-thirds of outstanding ordinary life insurance, the matter is more complicated. For these policies, the assumed rate is merely the guaranteed minimum. Ordinarily, it is set lower than the interest rate that the company expects to earn, in order to provide a margin of safety; and adjustments are made through policy dividends. If the assumed rate were used for participating policies, a considerable part of interest earnings on the reserves for these policies would continue to escape the individual income tax. In 1957, for example, the average assumed rate used by mutual life insurance companies, which generally issue only participating policies, was 2.72 per cent, compared with an average earned rate of 3.44 per cent for all life insurance companies.  

Use of the assumed rate for all policies would give the mutual companies a competitive advantage over the stock companies. On the other hand, use of the rate actually earned by each company on its portfolio might involve inequities in the treatment of different policyholders, who may not share equally in earnings. Policy dividends are not determined according to a rigid formula; nevertheless, management no doubt tries to share excess earnings equitably among classes of policyholders and in the process presumably comes fairly close to the result that would be obtained if a uniform earnings rate were applied to all policy reserves. As previously noted, mutual companies usually do not attempt to distribute all earned surplus to policyholders; hence, use of the actual earned rate would somewhat overstate the rate that policyholders can expect to enjoy. Perhaps the best solution would be to use a rate equal to say nine-tenths of the actual earned rate for mutual companies.

The method of income imputation outlined above, differs somewhat from Pechman’s suggestion that the amount to be included in policyholders’ income should be “the portion of the annual increases in cash surrender values that reflect interest earned on past savings.”  

34. 1959 Hearings, supra note 17, at 185; see Table 2 in text at p. 40.  
the reserve because of the amortization of initial expenses. Second, the increase in the reserve is less than the interest earned on the reserve in any year in which the premium is less than the cost of insurance. This is true of any fully paid-up policy and may be true of a straight-life policy when the insured reaches an advanced age (compare Table I). Third, the increase in surrender value does not reflect the actual earning rate and may not reflect the assumed rate.36

This brief review of the problems involved in the determination of interest income from life insurance savings makes it fairly clear that individual policyholders could not be expected to compute the amount of interest accruing to them annually. In order to include this item in taxable income it would seem necessary to require the insurance companies to make the calculations and to report the figures to policyholders and the Internal Revenue Service. If interest were imputed at the actual earnings rate on participating policies, annual reporting would be required. If the assumed rate were employed, as would be appropriate for nonparticipating policies, the companies could provide policyholders with a schedule that would show imputed interest income year by year as long as the face amount of the policy remained unchanged.

B. Collection of Tax

The incomplete coverage of ordinary interest and dividends under the income tax indicates that the mere reporting of imputed interest to policyholders and the Internal Revenue Service would not be enough to assure reasonably complete compliance with a requirement that this income be included in the tax base. As a means of dealing with the problem, it has been suggested that the tax be withheld by the companies or that the income be taxed at the maturity or surrender of a policy, rather than annually.

Pechman suggests withholding of tax but is not explicit about how this should be done.37 For participating policies it would be possible to require withholding of the policyholders’ liability (at the first-bracket rate) from dividends. This method, however, would be cumbersome, and it would be inapplicable to nonparticipating policies and unsuitable for participating policies when interest income exceeded earnings available for distribution. It seems that “withholding” by the insurance company would have to take the form of collection of an addition to the annual premium which would be remitted by

36. Under the Standard Nonforfeiture Law, the minimum surrender values are calculated, not on the mortality and interest rates assumed in the policy, but on a specified basis that is the same for all companies, the C.S.O. mortality table with interest at 3½%. Maclean, op. cit. supra note 2, at 184-86.

the company to the Internal Revenue Service and credited against the policyholder's tax liability.

The reporting and withholding procedure would involve inconvenience and expense for insurance companies, policyholders, and the Internal Revenue Service. An evaluation of these costs would require a more detailed survey than I have undertaken. The compliance burdens of the companies could be mitigated by the use of automatic data processing procedures which have been adopted by many of the large companies. The difficulties might be further reduced if the present exclusion were continued for interest income on individual policy reserves below some specified limit. A lower limit of $1,000 of reserves, corresponding to interest income of $30 to $35 a year, would exclude virtually all industrial life insurance and term insurance and a large fraction of other policies. Even with such a provision, the compliance burdens would appear to be great enough to cast grave doubt on the acceptability of the scheme.

Vickrey has suggested, in view of the difficulties in annual taxation of policyholders' income, that the interest income might be reported and taxed as a lump sum at the time of realization through loan, surrender or maturity of the policy, or death of the insured. This would involve bunching of income and hence in many cases an increase in tax liability unless provision were made for averaging. Realization on a policy through loan, surrender, or at the death of the insured, moreover, often occurs at a time of family financial difficulties. It would doubtless be considered harsh to impose an additional income tax at such a time. This approach might be more acceptable if it were applied only to policies issued after the change in the law than if applied to all policies, inasmuch as the new policyholders would have been placed on notice about their future tax liabilities with respect to interest realized on saving through life insurance.

C. An “IN-LEU” Tax on Insurance Companies

An alternative to the taxation of individual policyholders on imputed or realized interest income would be to impose a special tax on life insurance companies in lieu of the individual income tax. Lent has proposed for this purpose an additional flat-rate tax on net income allocated to policyholders (whether added to reserves or distributed in dividends), to be paid by the life insurance companies without distribution among individual policyholders. He suggests a rate equal to the first-bracket rate of the individual income tax, which might be reached only after a transition period of lower rates. Provision could be made for a tax credit to the policyholder if and when

the interest income was included in his return.³⁹

This proposal appears to be quite feasible from the administrative point of view. There would of course be only a very rough equivalence between the tax on the company and the liability that would arise if the interest income were taxed to individual policyholders. Some policyholders would be overtaxed and some would be under-taxed. The available statistics suggest that the amount of overtaxation would not be great if the rate applied to the companies were equal to the first-bracket rate of the individual income tax. Many policyholders would still find that life insurance had important tax advantages, but the discrimination in favor of life insurance would be considerably reduced.

A serious issue is raised by the possibility that the special tax on life insurance companies would make it difficult or impossible for some companies to meet reserve requirements and to discharge their obligations under outstanding policies. This result is not likely to occur under the present federal tax because life insurance companies are not taxed on investment income which is added to policy reserves. Lent suggests that in the case of participating policies the special tax would come out of dividends and that stock companies could recoup the tax on nonparticipating policies through premium loading charges. This would be possible if the tax were imposed in several steps over a long transition period, as Lent proposes, but probably would not be possible for many companies if a 20 per cent tax were abruptly applied to income attributable to outstanding policies. In 1957, for example, a 20 per cent additional tax would have reduced the average return on life insurance company investments from 3.44 per cent to 2.75 per cent. This is approximately equal to the average assumed rate of 2.72 per cent for mutual companies in that year but well below the 2.98 per cent average rate for stock companies.⁴⁰

If the special tax were imposed in several steps, as Lent suggests, the danger of bankrupting life insurance companies would be greatly reduced, if not completely avoided. New policyholders, however, would have to bear part of the tax properly assignable to interest on reserves for old policies, since the loading charge could be raised on new policies but not on old ones. The discrimination against buyers of new policies would be likely to be especially pronounced in the stock companies since these companies do not have as wide a margin between the earned rate and the assumed rate. This kind of discrimination could be avoided by limiting the tax to net income

⁴⁰ 1959 Hearings, supra note 17, at 185.
allocated to holders of policies issued after the legislation took effect, but this would lengthen the transition period.

V. Conclusion

Owing to the complexity of life insurance, a fairly subtle analysis is required to reveal the implications of the present tax status of policyholders' interest income. Yet it does not seem overly meticulous to argue that this form of investment income now enjoys preferential treatment that is hard to reconcile with widely accepted principles of tax equity, or to justify by reference to overriding considerations of social or economic policy. The interest earned on life insurance reserves is not small enough to be considered trivial. However, the difficulties of taxing individual policyholders on their imputed or realized interest income appear to be formidable, and objections can be readily advanced against proposals for an in-lieu tax on insurance companies. This may be a problem that has no fully satisfactory solution. The proven adaptability of the income tax to complex situations, nevertheless, encourages the hope that an improvement of the present situation can be devised by more detailed and ingenious study.