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Taxes and the "Inside Build-Up" of Life Insurance: Recent Issues

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Summary

Many life insurance policies contain both an insurance component and an investment element termed "inside build-up." The inside build-up receives favorable tax treatment under current law: a tax deferral (postponement) if a policy is surrendered for cash prior to death, or a tax exemption if paid out as part of death benefits. In the past, the tax treatment of inside build-up has received attention in the context of congressional consideration of legislation to repeal the federal estate tax. Under current law, assets transferred at death receive favorable tax treatment in the form of a "step-up" in basis. If repeal of the estate tax were to limit or repeal the step-up in basis, tax planners might consider investment in insurance policies with large inside build-ups as an alternative tax-saving strategy. Taxation of the inside build-up of insurance would rule out such a tax planning strategy and would thus reduce the revenue loss associated with repeal of the estate tax. However, provisions taxing the inside build-up of life insurance were not included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) — the omnibus tax cut bill that included a phase-out of the estate tax. Subsequent legislation passed by the House (but not the Senate) to extend the estate tax repeal have not included taxation of the inside build up. This report will not be updated.

"Inside build-up" in a life insurance policy occurs when the premiums on a policy are more than sufficient to pay for cost of the insurance during the period covered by the premium. For example, the actual cost of insuring a person's life is generally lower in the early years of a lengthy "whole life" policy than in the later years, when a person is older. Yet, such policies frequently are accompanied by "level premiums" — that is, the policies' premiums are the same throughout the policy's life, so that premiums paid early in the policy are higher than the actual cost of providing insurance. The excess is generally invested, earning a return (the inside build-up) that contributes to the cash value of the policy.

Subject to certain restrictions, inside build-up is not taxed under current law as it accrues. The ultimate magnitude of the tax benefit depends on the policyholder's disposition of the insurance policy. If a person surrenders a policy in exchange for cash, he or she is taxed on the cash value minus the value of premiums that have been paid. In this case, the inside build-up receives a benefit in the form of a tax deferral or postponement. Tax is ultimately paid on the inside build-up, but not until the policy is cashed in. (Note that the taxpayer receives an added tax benefit from the deduction of the premiums.) If a person keeps a policy until death, the proceeds of the policy are not subject to tax. In this case, the inside build-up is never taxed.[1]

A taxpayer's "basis" in an asset is best defined by reference to its practical function: it is the amount that can be deducted from the asset's sales proceeds when the asset is sold. It is the portion of the sales proceeds that represents the return of capital itself rather than the return *to* capital. Frequently, the basis is the asset's acquisition cost. When a person sells an asset — for example, stock — he is generally taxed on the sales proceeds minus his basis in the asset, or what he paid for it. Under current law, an heir's basis in an inherited asset is generally the asset's fair market value at the time of death rather than the decedent's basis in the asset. Thus, if the asset appreciated during the decedent's lifetime, the heir receives a "step up" in basis equal to the amount of that appreciation. If the heir subsequently sells the asset, he can therefore deduct the amount of appreciation that occurred during the decedent's lifetime and is effectively not taxed on that appreciation.[2]

Bills that propose repeal of the estate tax frequently place restrictions on the step-up in basis; the restrictions reduce the revenue cost of repealing the estate tax. In particular, both the House and Senate bills to repeal the estate tax that were passed in the first part of 2001 would limit the step-up in basis to $1.3 million plus $3 million of assets transferred to a surviving spouse. During the early consideration of the estate tax legislation, some suggested that any revenue gain from repealing or restricting the step-up in basis would be limited by the adoption of alternative tax-saving strategies by taxpayers seeking alternative ways to pass appreciated assets on to their heirs, free of tax. In particular, some suggested that taxpayers might divert investments to life insurance policies with a large inside build-up component. As noted above, if kept until death, such policies would not be subject to tax. In effect, they could transmit appreciation to heirs, free of tax, accomplishing a similar tax-saving function as the step-up in basis.[3]

The insurance industry has generally opposed subjecting the inside build-up of polices to tax. Neither the House nor the Senate versions of the omnibus tax cut bill Congress passed in May 2001 contained provisions taxing inside build-up of life insurance policies, nor did the version of the bill signed into law on June 7 as the Economic Growth and Tax Relief Reconciliation Act.

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[1] For a discussion of inside build-up and its tax treatment, see U.S. Congress, Senate, Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, prepared by the Congressional Research Service (Washington: GPO, December 2000), p. 149.

[2] For a discussion of the step up of basis, see CRS Report RL20875, *Step-up Carryover Basis for Capital Gains: Implications for Estate Tax Repeal*, by Nonna A. Noto (Washington: April 20, 2001), 14 pp.

[3] For a further disccusion, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Jane G. Gravelle and Steven Maguire, p. 23.

Since EGTRRA's enactment in 2001, Congress has actively considered making the estate tax repeal permanent. The House has passed a number of such measures, including H.R. 8 (108th Congress) in 2003 and H.R. 8 (109th Congress) in 2005. Also, in July, 2006, the House passed a compromise reduction of the estate tax (H.R. 5970) that would apply at the point EGTRRA's repeal expires. None of these bills contained provisions altering the tax treatment of the inside build-up in life insurance policies.

The inside build-up of life insurance was addressed in one of the two fundamental tax reform plans set forth by the President's Commission on Tax Reform in its final report of November 1, 2005. Under its Simplified Income Tax Plan, two new expanded vehicles for tax-favored savings would be implemented; one would be linked to retirement and one would not. These expanded accounts would generally replace current law's tax-favored savings mechanisms such as Individual Retirement Accounts and the inside build-up of insurance policies. Under the plan, the increase in value of insurance policies would be treated as current income and subject to tax on an annual basis, although insurance policies could also receive preferential treatment if purchased through one of the plan's savings vehicles. According to the Commission's report, such treatment would constitute a more neutral treatment of saving through insurance compared to other savings instruments.[4] Congress has not yet begun to actively consider legislation that embodies the Commission's proposal.

[4] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington: 2005), p. 123. The report is posted on the internet, at [http://www.taxreformpanel.gov/final-report/]. The second of the Commission's tax reform plans is generally a consumption tax, under whose terms the inside build-up of insurance — like income from other savings — would implicitly be tax exempt.