Recent proposals would eliminate the Separate Account Dividends-Received Deduction (DRD) for life insurance corporations.

Total federal tax burden (corporate + individual taxes) on:	**Existing tax rules**	**Recent proposals**
Saving for retirement through a life insurance corporation	68%	66%
Saving for retirement through any other U.S. corporation	65%	58%
Higher tax burden:	*3%*	*8%*

- Under the existing Separate Account DRD rules, saving for retirement through a life insurance corporation already faces a higher tax burden than saving for retirement through any other U.S. corporation.
- Recent tax reform proposals – like the Camp Draft and the President's Budgets – would further increase this tax burden. They could result in triple taxation on saving for retirement through a life insurance corporation.
- This higher tax burden could increase the price, and reduce the availability, of life insurance products that provide unique protections to people who are trying to build their financial and retirement security.

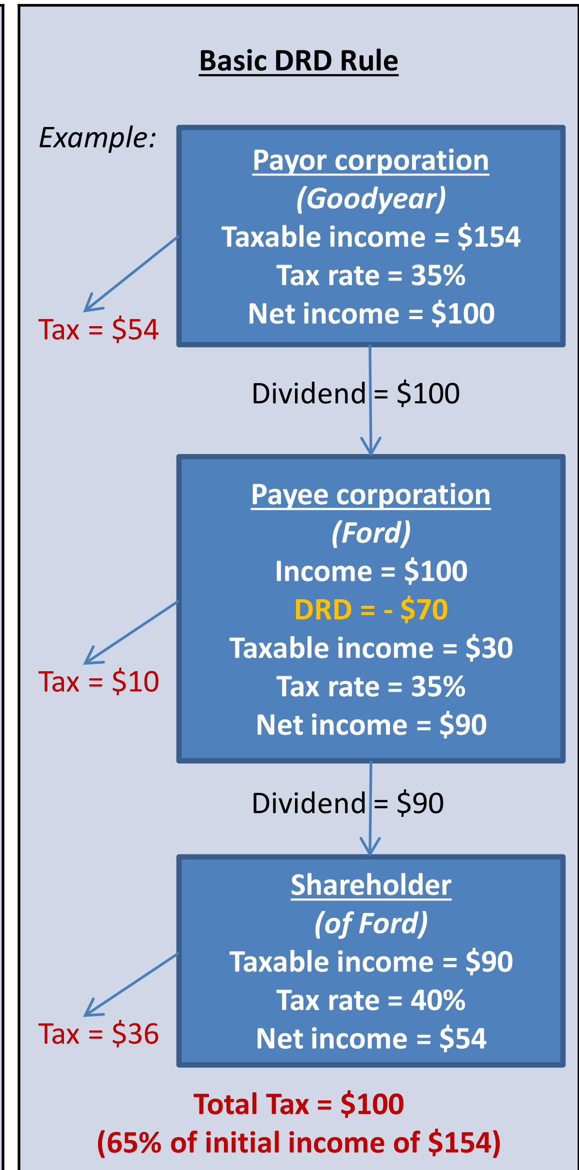
The basic DRD rule is designed to minimize triple taxation.

Recent Separate Account DRD proposals assume that the existing tax rules give a special benefit to life insurance corporations. But that assumption is incorrect.

1. **The basic DRD rule was added to the Internal Revenue Code in order to minimize the triple taxation of income that's earned through corporate structures:**
   - **This happens frequently – whenever one U.S. corporation invests in another one: for example, if Ford buys stock in Goodyear, to ensure a steady supply of tires for its cars. The Goodyear stock then pays dividends.**
     - **Goodyear pays dividends from income that was already fully taxed.**
     - **If Ford had to pay full corporate tax on its dividends from Goodyear, the same income would be fully taxed twice at the corporate level.**
     - **Later, when Ford pays a dividend to its own individual shareholders, that dividend will be taxed for a third time – at ordinary income rates assuming the Ford shares are held in a retirement-savings account.**
   - **So without the basic DRD rule, the same stream of income could be fully taxed three times:**

     (35%) + (35% of the remainder) + (40% of the second remainder)
     = 75% of the initial income, taxed away (at the federal level alone).
   - **The basic DRD rule – shown to the right – allows the payee corporation to claim a deduction equal to 70% of the dividend it received. This eliminates most of the second layer of tax on income earned through a corporate structure:**

     (35%) + (10% of the remainder) + (40% of the second remainder)
     = 65% of the initial income, taxed away at the federal level.



Less favorable DRD rules apply to life insurance corporations.

2. **The basic DRD rule applies to almost all U.S. corporations. But less favorable rules – the Separate Account DRD rules – apply to saving for retirement through a life insurance corporation. These Separate Account DRD rules *always* result in higher taxes. So under existing law, saving for retirement through a life insurer separate always has a higher tax burden:**

   - **Saving for retirement through an insurer separate account starts when the life insurance corporation invests premiums in the stock market. Some of those stocks then pay dividends.**

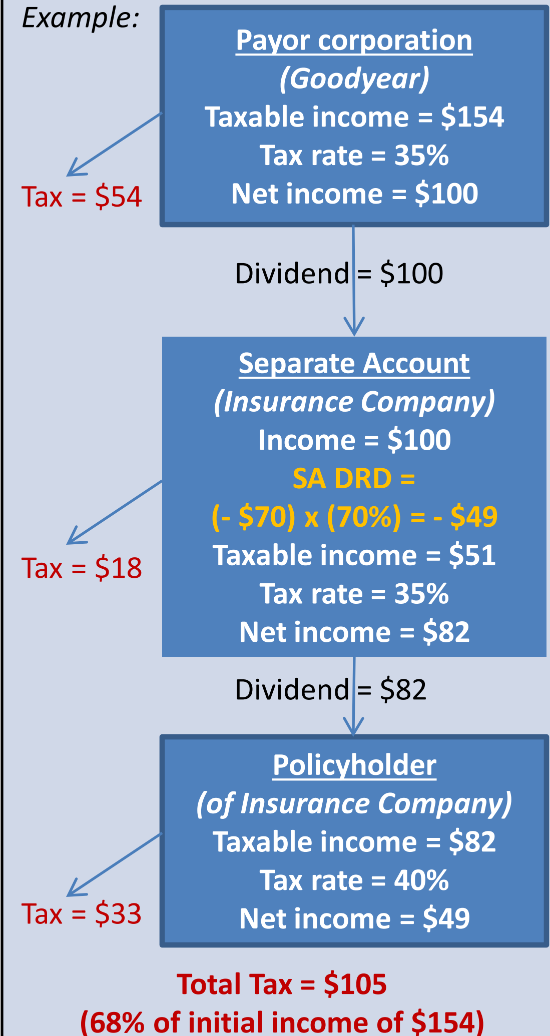
   - **When the insurer separate account receives a dividend, the existing Separate Account DRD rules require the basic DRD amount to be reduced by the "policyholder share" of net investment income. This reduction varies from insurer to insurer; the example to the right assumes a reduction of 30%.**

   - **Because of that reduction, the existing Separate Account DRD rules already impose a higher tax burden on insurer separate accounts. In the example,**

     (35%) + (<u>18%</u> of the remainder) + (40% of the second remainder)
     = <u>68%</u> of the initial income, taxed away at the federal level.

   - **The basic DRD rule results in a <u>65%</u> total federal tax burden – so it's clear that under existing law, saving for retirement through insurer separate accounts results in 3 percentage points more in federal taxes, compared to any other U.S. corporation.**

***<u>To sum up</u>*: The existing Separate Account DRD rules do <u>not</u> give a special benefit to life insurance corporations or their policyholders. On the contrary: Under existing law, saving for retirement through insurer separate accounts is taxed more heavily than saving for retirement through any other U.S. corporation.**



Sound tax policy does not support the limit on the Separate Account DRD.

3. **The rules for limiting the Separate Account DRD were added by the Deficit Reduction Act of 1984. The stated rationale was to prevent life insurers from receiving a "double deduction" – that is, the DRD *plus* a separate deduction for increased reserves:**

> **"Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. *Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends*." (Joint Committee Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 625, emphasis added.)**

4. **But the stated rationale for these rules dissolves under any real scrutiny. It ignores the fact that every other U.S. corporation receives the basic DRD, in full, *plus* a separate deduction for all the other costs incurred in creating products for its customers:**
   - **Go back to the example of Ford investing in Goodyear, to ensure a steady supply of tires for its cars. When Ford receives a dividend from Goodyear, Ford is clearly entitled to a DRD – to minimize the triple taxation of income that's earned through a two-corporation structure. Just as clearly, Ford is *also* entitled to a separate deduction for its cost of goods sold, capital asset depreciation, and other ordinary and necessary expenses incurred to produce the cars it sells. No one argues that any part of the Goodyear dividend "belongs" in any sense to the shareholders who had invested in Ford's stock – so that Ford's DRD should be reduced by the "shareholders' share" of the Goodyear dividend.**
   - **But the stated rationale for the rules for limiting the Separate Account DRD makes *precisely* this argument. An insurer invests in shares of other corporations, to ensure a steady supply of income to fulfill the promises the insurer has made to its Separate Account policyholders. When the insurer receives dividends from those corporations, the insurer is clearly entitled to a DRD – to minimize the triple taxation of income that's earned through a two-corporation structure. Just as clearly, the insurer is *also* entitled to a separate deduction for the reserve increases necessary and appropriate to meet its obligations to its Separate Account policyholders. Under those circumstances, why should *any* part of the insurer's DRD be regarded as a "double deduction"?**

***To sum up*: The stated rationale for the existing rules for limiting the Separate Account DRD has no substance. It draws a distinction where there's no difference, between taxpayers who are in essentially identical economic positions.**

Consistent with the goals of tax reform, the DRD rule should follow the principle of *tax neutrality*.

5. The real rationale for the basic DRD rule is that it contributes to *tax neutrality* within the Internal Revenue Code.

- **The principle of tax neutrality is a structural concept underlying the Code: the concept that U.S. tax laws should encourage taxpayer decisions to be made on the basis of their true economic merits – not for tax reasons. Tax neutrality is a long-standing goal of sound tax policy: It increases the efficiency of capital allocation throughout the economy, and reduces the incentive for a wasteful focus on tax-avoidance efforts – which depend on form rather than substance.**
- **By minimizing the triple taxation of income that's earned through a two-corporation structure, the basic DRD rule contributes to tax neutrality: The rule reduces a tax disadvantage that would otherwise be imposed on certain recipients of capital income, based merely on the legal form in which they're organized – namely, on taxpayers who receive dividend income through a two-corporation structure, rather than through a single corporation or a partnership.**

6. But the existing rules for limiting the Separate Account DRD contradict the principle of tax neutrality:

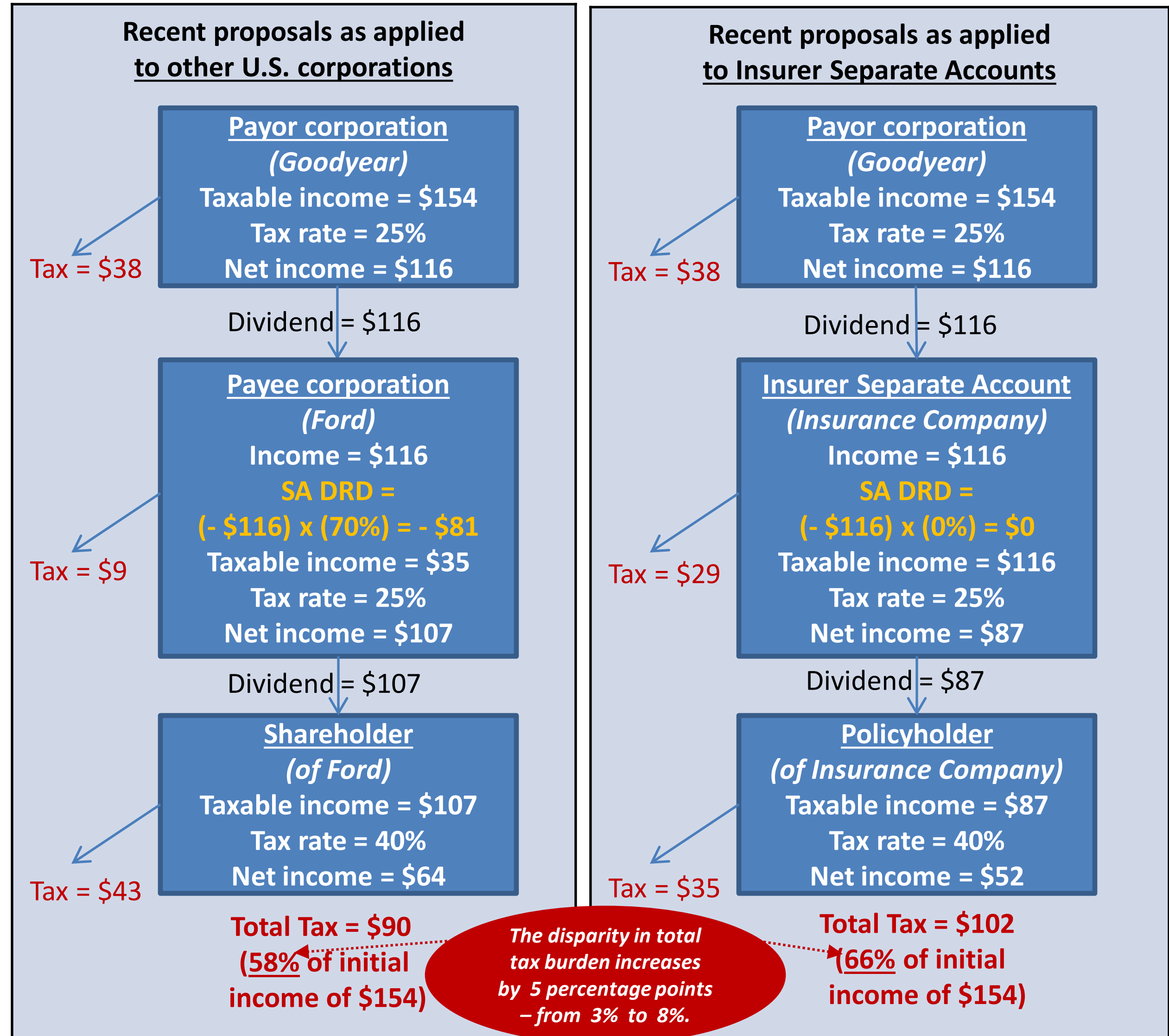
- **Under those rules, saving for retirement through insurer separate accounts faces a tax disadvantage of 3 percentage points, compared to saving for retirement through any other U.S. corporation.**
- **In other words, the existing rules for limiting the Separate Account DRD actually *create* a tax disparity – a tax disadvantage that's being imposed on certain recipients of capital income, based merely on the legal form in which they're organized. And in the case of life insurance corporations, that's the legal form in which they're required to be organized. That's the exact opposite of tax neutrality (and the opposite of a "tax expenditure" or "loophole").**

***To sum up*: The existing rules for limiting the Separate Account DRD focus on the "policyholder share" versus the "company's share." But the focus should really be on the "policyholder share" versus the "Government's share" of the total stream of income. With that focus, it's clear that under existing law, saving for retirement through insurer separate accounts is taxed more heavily than saving for retirement through any other U.S. corporation. That disparity in tax burden contradicts the principle of tax neutrality – which is the only real justification for the basic DRD rule in the first place.**

Recent proposals would treat saving for retirement through insurer separate accounts even less favorably than the existing tax rules do.

7. **Recent proposals would go further, and eliminate the Separate Account DRD entirely. That would be undesirable for two distinct reasons:**

- ***Undesirable as tax policy*: The recent proposals would impose triple taxation only on saving for retirement through an insurer separate account. Such selective tax disparity contradicts the principle of tax neutrality even more than existing law does.**
- ***Undesirable as social policy*: The recent proposals would increase the tax disadvantage on saving for retirement through an insurer separate account -- from 3 percentage points up to 8 percentage points. That could frustrate the efforts of many ordinary Americans who are trying to build their financial and retirement security.**



These recent proposals could also have undesirable social-policy effects.

7. **The recent proposals to eliminate the Separate Account DRD could frustrate the efforts of many ordinary Americans who are trying to build their financial and retirement security. That's an undesirable social policy, especially since other sources of financial and retirement security – such as employer pension plans and Social Security – are already under great strain.**

   - **People trying to build their financial and retirement security have two main concerns:**
     - **<u>Mortality/morbidity risk</u> – *"What happens if death or sickness prevents me from providing for my loved ones?"***
     - **<u>Longevity risk</u> – *"What happens if I live so long that I outlive my retirement savings?"***

   - **Life insurance products – specifically, variable life and annuity contracts that allow the insurer to invest the premiums in the stock market – provide a uniquely efficient means of saving for retirement, while also protecting against both mortality and longevity risks.**

   - **But under recent proposals, the tax disadvantage faced by these particular life insurance products would increase – from 3 percentage points up to 8 percentage points. Variable annuity contracts could become much more expensive, making people less able or willing to buy them. The overall effect could be to discourage people from using this uniquely efficient means of saving for retirement – and a general reduction in financial and retirement security.**

   - **In this respect, the recent proposals are similar to another provision in the Deficit Reduction Act of 1984, which applied the same "policyholder share" analysis to life insurers' investments in tax-exempt bonds:**

     - **This provision reduced the economic value of tax-exempt bonds to life insurers – and in response, life insurers do not make significant investments in tax-exempt bonds.**

     - **But the absence of life insurers from the tax-exempt bond market doesn't harm the life insurers – instead, it can only harm the issuers of the bonds. Reduced market demand could cause the issuers to offer higher interest rates on their bonds. Those higher rates, in turn, would reduce the benefit Congress intended to give the issuers when they were granted the authority to issue tax-exempt bonds.**

     - **The same sequence of events – reduced economic value to insurers, leading to their reduced participation in the market, and ending in higher costs for people whom Congress didn't intend to harm – is likely to occur if any of the recent proposals to eliminate the Separate Account DRD were enacted into law.**