

GAO

Report to the Honorable  
Fortney H. (Pete) Stark, House of  
Representatives

June 1988

# TAX POLICY

## Mortality Charges on Single Premium Life Insurance Should Be Restricted



042565/136198





United States  
General Accounting Office  
Washington, D.C. 20548

General Government Division

B-229198

June 14, 1988

The Honorable Fortney H. (Pete) Stark  
House of Representatives

Dear Mr. Stark:

In a May 25, 1988, briefing of the staffs of the various congressional tax-writing committees, we discussed the tax policy issues that arise because life insurance companies can, under current law, charge higher premiums on single premium life insurance by specifying greater-than-standard mortality or risk charges. After the briefing, you requested that we present our findings in a report. This report discusses the results of our work and supplements our past report and testimony entitled Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR, Oct. 16, 1987 and GAO/T-GGD-88-20, Mar. 15, 1988).

Single premium life insurance policies allow one large premium to be paid up front and combine death benefits with earnings which accumulate tax free. Policyholders can also obtain loans from the policies at little or no cost because the income on funds invested is used to offset the interest charged to borrow. Thus, the policies provide a means for capturing investment income without reflecting it on an income tax return.

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## Results in Brief

Current law allows life insurance companies to set their premiums based on the mortality charges specified in the policy. This makes it possible to enhance the policy's investment potential because companies can specify higher mortality charges—charges in excess of those normally considered reasonable for a life insurance contract. Higher mortality charges can be used to provide insurance to individuals who are considered substandard risks. However, they can also be used to artificially inflate premiums for individuals normally considered standard risks. On investment-oriented products like single premium life insurance, policyholders are able to shelter more money for investment and more funds are available for low-cost, tax-free policy loans. In an examination of 40 single premium life insurance policies, we found that 8, or 20 percent, stated a maximum mortality charge that was based on a rate of at least 200 percent, or two times the standard rate.

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## Objectives, Scope, and Methodology

The objectives of this review were to (1) examine the tax policy issues that arise because life insurance companies can use higher-than-standard mortality charges to increase premiums on single premium life insurance products and (2) assess how proposals to change the tax status of investment-oriented life insurance address increased mortality assumptions.

To examine the tax policy implications of life insurance mortality charges, we reviewed laws, regulations, and documents on the taxation of life insurance products. We also reviewed testimony by various industry groups, including the National Association of Life Underwriters (NALU) and the American Council of Life Insurance (ACLI), on the investment uses of life insurance. This testimony was delivered on March 15, 1988, during hearings before the House Ways and Means Subcommittee on Select Revenue Measures.

To determine whether or not companies actually specify higher-than-standard mortality charges in single premium life insurance contracts, we reviewed mortality charges and insurance premiums on 40 single premium policies that various life insurance companies submitted to the Insurance Administration of the District of Columbia. We collected all available single premium contracts that were filed during the 5-year period ending June 1987. The policies were filed with the Insurance Administration for approval for sale in the District of Columbia and were provided at our request during our earlier review of single premium life insurance taxation. Our analysis of these policies included (1) an actuarial examination of each policy's mortality charge, interest rate, and single premium and (2) a simple regression analysis of the relationship between single premiums and the mortality charges specified.

To examine the effect of higher-than-standard mortality charges on life insurance premiums, we computed the net single premiums for various ages using standard mortality tables and specific multiples of the mortality assumptions used in those tables. In computing premiums, we referred to the mortality rates provided in the Commissioners Standard Ordinary (CSO) Tables contained in A.M. Best's Flitcraft Compend for 1987. The CSO tables are actuarial tables used by various states to establish minimum reserves and reflect the probability of death at any given age.

Our review was done during April and May 1988 in accordance with generally accepted government auditing standards.

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## Current Law Provides Flexibility With Respect to Mortality Charges

Current law provides favorable tax treatment to life insurance products but attempts to restrict the extent to which life insurance can be used as an investment. Section 7702 of the Internal Revenue Code defines as life insurance any contract that is considered life insurance under law, but only if the contract satisfies either of two alternative tests. Under the cash value accumulation test, a life insurance contract's cash value cannot be more than the net single premium needed to pay all future benefits. Under the guideline premium limitation and cash value corridor test, the premiums cannot exceed certain guideline levels and the death benefit cannot be less than a set proportion of the policy's cash value based on the age of the insured. Once a policy meets either of these conditions, policy earnings accumulate tax free, loans from earnings are not subject to current taxation, and proceeds are not subject to income tax if paid by reason of the death of the insured.

In order to satisfy either of the tests established under section 7702, a life insurance policy must be designed within the context of certain actuarial assumptions. One of these pertains to a policy's mortality charge, which accounts for such factors as the age, health, and probability of death of the insured.

Under current law, maximum mortality charges under either of the two alternative tests can be specified in the contract. If none is specified, the mortality charge is limited to that used in determining reserves as required by the states. Reserve requirements are set to assure a company's solvency in the face of future claims. On the other hand, a company that specifies maximum mortality charges in the contract is allowed to charge a single premium based on this mortality assumption.

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## Higher Mortality Charges Can Enhance the Investment Attributes of a Contract

Even though a company may specify maximum mortality charges in its life insurance contracts, it does not have to charge premiums based on these mortality assumptions. However, higher-than-standard mortality assumptions give companies the opportunity to charge higher premiums without increasing death benefits. On products like single premium life insurance, larger premiums can substantially enhance the investment attributes of the contract because more funds are available for investment and policy loans.

To determine whether or not life insurance companies use the flexibility allowed by section 7702, we examined 40 single premium life insurance contracts that were filed by different companies with the Insurance

Administration of the District of Columbia. All 40 policies were for a 35-year-old male. Of the 40 contracts,

- 8, or 20 percent, did not specify a mortality charge and accordingly, based the mortality charge on the statutory reserve requirements of the District of Columbia;
- 24, or 60 percent, stated a maximum mortality charge that reflected mortality no higher than 190 percent, or 1.9 times the standard rate; and
- 8, or 20 percent, stated a maximum mortality charge that was based on a rate of at least 200 percent, or two times the standard rate.

Table 1 shows the maximum mortality charges, converted to a multiplier of the CSO tables, stated by the 32 companies that specified the charges in the contract.

**Table 1: Maximum Mortality Charges Specified in 32 Single Premium Contracts as a Multiple of CSO Tables**

Multiple <sup>a</sup>	Number of contracts
Less than 1.0	2
1.0	6
1.1 to 1.9	16
2.0 to 2.9	5
6.0	1
10 and above	2

<sup>a</sup>A multiple of one (1.0) refers to standard mortality at age 35 as derived from either the 1980 or the 1958 CSO Tables. In some contracts, that multiple can be lower or higher depending on the age of the insured. For example, the two policies that stated a maximum mortality charge of 10 and above (10.71 and 11.27) had a decreasing multiple each year after age 35. By age 85, the multiple decreased to 3.16 and 2.9 respectively.

Source: Data used in the preparation of this table was obtained from single premium policies filed with the Insurance Administration for the District of Columbia.

To show the extent to which a mortality charge can affect a policy's investment potential, we calculated the net single premium (without loading for expenses) at two levels of mortality charges and at various ages. Table 2 illustrates the net single premium on a policy with a \$100,000 death benefit under the cash value accumulation test and shows the maximum annual loan allowed under the policy. Table 3 illustrates net single premiums and loans on the same size contract under the guideline premium limitation. The tables show that with increased mortality charges, a policy's net single premium can be substantially increased.

**Table 2: Net Single Premiums and Loans by Age and Mortality Charge Under the Cash Value Accumulation Test**

Death Benefit - \$100,000; Current Interest Rate - 8 percent

Age	Standard mortality		Standard mortality multiplied			
	Net single premium	Maximum annual loan	150 percent		600 percent	
			Net single premium	Maximum annual loan	Net single premium	Maximum annual loan
35	\$24,682	\$1,975	\$28,800	\$2,304	\$46,629	\$3,730
45	34,071	2,726	39,182	3,135	59,295	4,744
55	45,794	3,664	51,697	4,136	72,214	5,777
65	59,126	4,730	65,237	5,219	83,383	6,671
75	72,389	5,791	77,870	6,230	91,443	7,315

Source: Data used in the preparation of this table obtained from the 1980 CSO mortality table and section 7702 (b)(2)(A) of the Internal Revenue Code.

**Table 3: Net Single Premiums and Loans by Age and Mortality Charge Under the Guideline Premium Limitation**

Death Benefit - \$100,000; Current Interest Rate - 8 percent

Age	Standard mortality		Standard mortality multiplied			
	Net single premium	Maximum annual loan	150 percent		600 percent	
			Net single premium	Maximum annual loan	Net single premium	Maximum annual loan
35	\$13,951	\$1,116	\$17,327	\$1,386	\$33,988	\$2,719
45	21,861	1,749	26,582	2,127	47,454	3,796
55	33,034	2,643	39,133	3,131	62,570	5,006
65	47,235	3,779	54,216	4,337	76,743	6,139
75	62,811	5,025	69,634	5,571	87,657	7,013

Source: Data used in the preparation of this table obtained from the 1980 CSO mortality table and section 7702 (c)(3)(B)(iii) of the Internal Revenue Code.

We examined the 32 single premium policies collected from the District of Columbia to determine the extent to which companies were basing the single premium on the maximum mortality charge stated in the contract. On the basis of a statistical analysis of the 32 policies, we found a strong correlation between the single premium used and the maximum mortality charge specified. For example, a policy for a 35-year-old male which qualifies under the cash value accumulation test used a single premium of \$44,092 and stated a maximum mortality charge of 600 percent. Under the cash value accumulation test, the maximum allowable single premium at a 600 percent mortality charge is \$46,629, as shown in table 2. Another policy which qualifies under the guideline premium limitation used a single premium of \$16,766 for a male age 35 and stated

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a maximum mortality charge of 150 percent. Under the guideline premium limitation, the maximum single premium allowable at a 150 percent mortality charge is \$17,327, as shown in table 3.

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## Recent Legislative Proposals

Three recent legislative proposals would attempt to curtail the tax advantages associated with investment-oriented life insurance although none deals directly with higher-than-standard mortality charges. However, a proposal advanced by us contains two alternatives that would discourage higher-than-standard mortality charges by either reducing or eliminating the investment orientation of certain types of life insurance products. Likewise, a proposal put forth as the Stark-Gradison bill (H.R. 3441) would have similar consequences. In contrast, a third proposal advanced by the life insurance industry would not affect increased mortality charges because, in our opinion, investment-oriented products would not be sufficiently discouraged.

In our March 1988 testimony on the taxation of single premium life insurance, we recommended that Congress consider measures that would eliminate the tax advantage associated with investment-oriented single premium life insurance products. We presented two alternatives which would change the tax status of single premium life insurance. One would tax loans from single premium policies as income in the year withdrawn. The second would revise the cash value corridor test under current law to disqualify contracts from favorable tax treatment if loans reduced death benefits below certain levels. Unlike our first alternative, it would not require an explicit definition of investment-oriented life insurance. Instead, it would change the corridor test under existing law to require that the net death benefit (the death benefit minus loans) be compared to the contract's account value when one is determining whether or not the policy qualifies as life insurance for tax purposes.

Because both of our alternatives would reduce or eliminate the investment potential of single premium life insurance, they should lessen the incentive for companies to specify higher mortality charges. However, our second alternative would more directly remedy this problem because higher-than-standard mortality assumptions would increase the contract's single premium and, as a result, increase the policy's account value for a given amount of insurance. Consequently, under our proposed definition of the corridor, the ratio of the net death benefit to the account value would be lower and policy loans would disqualify the policy more quickly.



For example, on a policy with a death benefit of \$89,086 and a standard mortality charge, the single premium, including loading for expenses, is \$25,000. If the company declared a current interest rate of 8.35 percent, the policyholder could borrow \$2,088 each year. Under our proposed change to the corridor, the contract would be disqualified from favorable tax treatment in the eighth policy year. However, if the mortality assumption is increased to 150 percent, the single premium would be \$28,652 and the policyholder could borrow \$2,392 each year at the 8.35 percent declared interest rate. With the higher mortality charge and its corresponding higher single premium, the policy would be disqualified from favorable life insurance tax treatment in the sixth policy year. The appendix illustrates the effect of our proposal to revise the corridor test on this policy with a premium based on the standard mortality charge and the mortality charge increased to 1.5 times standard mortality.

The Stark-Gradison bill (H.R. 3441) provides another approach for dealing with investment-oriented life insurance and would also remove the incentive to increase mortality charges. H.R. 3441 would tax distributions, including loans, as income in the year withdrawn on all life insurance products and would place a 10-percent penalty on all taxable distributions before age 59-1/2. Like our first alternative, which only addresses single premium life insurance, the tax on distributions should discourage the purchase of life insurance as an income-producing investment because loans would no longer be available to provide tax-free income. Thus, artificially-inflated charges would likely be discouraged because they are only attractive to consumers when they increase the investment value of the policy. Without tax-free loans, higher priced insurance would probably not be a viable product.

The industry proposal put forth by ACLI, NALU, and the Association for Advanced Life Underwriting (AALU) likewise attempts to limit the use of investment-oriented contracts but would not be nearly as effective in discouraging higher mortality charges. The proposal would apply an annual funding limit for the first 5 years of a life insurance contract. If the premium exceeded the limit in any of the 5 years, the policy would become a "modified endowment" contract whereby distributions would be taxed for the first 10 years. Aside from the tax on distributions, the contract would still retain the tax advantages accorded life insurance.

Although the industry proposal would dampen the investment orientation of some life insurance products, policy loans would still be available on products that meet the 5-year funding limit. Because of the ability to

take loans, policies with increased premiums that result from higher mortality charges would still be attractive.

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## Conclusions

Section 7702 of the Internal Revenue Code gives life insurance companies the option of increasing mortality charges to enhance the investment appeal of certain life insurance products. Policies that are designed with increased mortality assumptions have larger premiums and increase the amount available for tax-free policy loans.

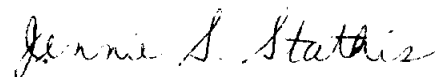
Several proposals have been offered to eliminate tax advantages associated with single premium life insurance. Whichever alternative is chosen should be one designed to limit the tax advantages associated with using mortality charges to enhance the investment attributes of a life insurance contract.

In our previous work, we recommended that Congress consider legislative remedies that would eliminate the tax advantages associated with investment-oriented single premium life insurance products. We continue to support this recommendation and believe that our proposal to revise the cash value corridor test would be an effective approach because it would eliminate excessive borrowing and reduce the incentive to inflate mortality assumptions.

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As requested by your office, we did not obtain official comments on this report. We are sending copies of this report to the Secretary of the Treasury and other interested parties and will make copies available to others upon request. If you have any questions regarding this material, please contact Mr. Natwar Gandhi of my staff on 272-7904.

Sincerely yours,



Jennie S. Stathis  
Associate Director

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# Effect of Borrowing If the GAO Revised Corridor Test Were Adopted

**Table I.1: Standard Mortality Charge**

Male Age 47 Premium - \$25,000 Death benefit - \$89,086 Current interest rate - 8.35%						
Policy year	Accumulated account value	Annual loan	Cumulative loan at end of year <sup>a</sup>	Death benefit after loan	Ratio of death benefit to accumulated account value	
					GAO's revised corridor test	Minimum allowed by law
1	\$27,088	\$0	\$0	\$89,086	329%	203%
2	29,300	2,088	2,213	86,873	296	197
3	31,646	2,088	4,559	84,527	267	191
4	34,132	2,088	7,046	82,040	240	185
5	36,767	2,088	9,682	79,404	216	178
6	39,561	2,088	12,476	76,610	194	171
7	42,522	2,088	15,438	73,648	173	164
8	45,661	2,088	18,578	70,508	154	157

<sup>a</sup>Cumulative with interest at 6 percent.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.

**Table I.2: Mortality Charge Inflated 1.5 Times**

Male Age 47 Premium - \$28,652 Death benefit - \$89,086 Current interest rate - 8.35%						
Policy year	Accumulated account value	Annual loan	Cumulative loan at end of year <sup>a</sup>	Death benefit after loan	Ratio of death benefit to accumulated account value	
					GAO's revised corridor test	Minimum allowed by law
1	\$31,044	\$0	\$0	\$89,086	287%	203%
2	33,579	2,392	2,535	86,551	258	197
3	36,267	2,392	5,223	83,863	231	191
4	39,116	2,392	8,072	81,014	207	185
5	42,135	2,392	11,091	77,995	185	178
6	45,335	2,392	14,291	74,795	165	171

<sup>a</sup>Cumulative with interest at 6 percent.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.

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