

ACLI Submission Letter to Business Income Tax

In efforts to reform the tax Code, Congress should look to the life insurance industry as a partner that encourages families and businesses to plan for the long term and protect their financial and retirement security. The products that our policyholders use to build a personal safety net, including those provided through the workplace, are vital to a well-functioning society and, for millions of families, build on the floor of financial security that government programs provide. It also is important for businesses of all sizes, which often purchase life insurance to protect jobs after the death of an owner or key employee and to finance employee benefits. The protections and guarantees our products offer are not available from any other financial services companies.

As the Working Group on Business Income Tax continues its work, we would highlight for you the unique nature of the life insurance business model and some of the differentiating factors to consider in the context of tax reform:

- The life insurance industry already bears a significant tax burden under current law and is impacted in a multi-dimensional way in tax reform.
 - Life insurance and retirement savings products are taxed appropriately under current law. The savings that build up in life insurance, annuities and other retirement savings products do not escape taxation. They are taxed at ordinary income tax rates when people make withdrawals from their retirement savings or annuity, or cash in their life insurance policies if protection is no longer needed. Additionally, life insurance and annuity owners pay premiums with after-tax dollars.
 - Life insurers account for 1.7 percent of corporate profits, but pay 2.5 percent of corporate sector tax revenue.
 - Tax reform has a layered impact on life insurers because general corporate, insurance-specific, investment, and international tax provisions apply to our companies, and individual provisions relate to our products and retirement savings. These interrelationships and their cumulative effects must be acknowledged as tax reform is considered.
- Life insurance companies generally are taxed like corporations in other industries, but they are subject to additional, specific life insurance-related provisions in the Internal Revenue Code. These insurance-specific provisions, found in Subchapter L of the tax Code, reflect the role of state insurance regulation to which insurers are subject as well as the unique financial model under which they operate. These insurance-specific provisions generally result in higher tax liabilities for life insurance companies. Life insurers are:
 - Denied a current deduction for their selling costs through the Deferred Acquisition Cost (DAC) tax.
 - Subject to additional restrictions on their dividends-received deduction (DRD) that do not apply to companies in other industries.

- Often subject, unlike any other industry, to severe restrictions on their ability to file consolidated income tax returns and offset gains and losses with their affiliated non-life companies.
- Subject to capital tax treatment of assets used in the ordinary course of their business, rather than ordinary tax treatment, which also leads to a mismatch and an inability to fully offset taxable losses against taxable income.
- Reserves are the liabilities companies are required to establish by state insurance regulators. They represent the regulators' estimate of the amount needed to cover expected future claims, and the tax deduction for reserves can never exceed the liability required by the regulator. The reserve deduction for increases in reserve liability for future life and annuity policy benefit claims is foundational. This insurance-specific provision in Subchapter L reflects the unique business model through which our products deliver on their protections and guarantees years or decades after premiums are first received.
- The tax deduction for an increase in reserves is appropriate to ensure that life insurers' income and expenses are properly matched to the year/accounting period when those items arise. Without a deduction for increases in reserves, life insurers' taxable income would be inappropriately accelerated, causing them to be effectively taxed on a gross income basis rather than on a net income basis. The U.S. system of income taxation does not tax any industry on a gross income basis.

Life insurers make long-term promises that are a function of investment performance and underwriting success over time. Subchapter L provisions do a reasonably accurate job measuring life insurers' income. If changes are contemplated to insurance-specific provisions, the industry must be involved in these deliberations.

The nature of insurance company product design means that given the long-term contractual and pricing constraints of current contracts, the burden of changes to the tax Code falls disproportionately on future policyholders and customers, including business owners providing employee benefits and protections through products. Changes to the tax treatment of either products or life insurance companies would affect the availability and affordability of our products at the very point in time that private sector protections and guarantees are needed most to backstop strained public safety nets.

Attached are additional materials specific to the Working Group on Business Income Tax. We ask that you consider the overarching themes here as you address reforms related to our industry.

April 15, 2015

NEW TAXES ON THE LIFE INSURANCE INDUSTRY: MORE BARRIERS TO FINANCIAL AND RETIREMENT SECURITY

The life insurance industry acknowledges the dedicated efforts to update and simplify the nation's tax code in Chairman Camp's discussion draft. We appreciate the recognition of the importance of many life insurers' products within the discussion draft released in February. However, the new tax regime outlined—with its significant increase in taxes on the life insurance industry—creates more barriers to financial and retirement security for American families.

Life insurers offer the products and services that make families more financially secure and businesses more stable. In light of the nation's need for long-term savings and financial security, tax proposals that target life insurers—and the businesses and families that rely on their products—are the wrong course for policy-makers to take.

PUBLIC POLICY SHOULD ENCOURAGE FINANCIAL SECURITY

Families and businesses alike need financial stability and count on life insurers' products for peace of mind, long-term savings, retirement planning, and guaranteed lifetime income. Savings in permanent life insurance and annuities alone represent almost 20 percent of Americans' long-term savings in this country. Our nation's public policies have historically recognized the importance of encouraging families and businesses to save more, plan responsibly, and protect their financial security. These policies should continue to encourage people, and businesses, to plan for the future and protect against financial risks—particularly in light of the strains on the public safety net.

The long-term guarantees offered by the industry are more important than ever with people living longer and families looking for more stability in planning for retirement. Over the next 15 years, approximately 10,000 people will turn 65 every day. It is clear that our nation needs the innovative protection and savings products that our industry provides. The proposal's goal of spurring economic growth and job creation will not mitigate the adverse impact on long-term security and protection against risk that will be a consequence of this draft.

NEW TAXES ON THE LIFE INSURANCE INDUSTRY AND RETIREMENT HURT CONSUMERS AND LONG-TERM SAVINGS

Imposing new taxes on life insurance companies effectively imposes new taxes on life insurers' products. This discussion draft would make the products that help American families and businesses obtain financial and retirement security more expensive—and hinder long-term savings. It will make it more difficult for companies, agents, and financial advisors to provide reliable and stable options for planning for the future.

In addition, the discussion draft proposes new taxes on retirement savings and other limitations, thereby creating significant impediments to Americans' much-needed retirement readiness efforts. The House Ways & Means Committee—indeed, all of Congress—should focus on expanding opportunities for individuals to save for retirement and for employers to voluntarily offer workplace retirement plans.

MOVING FORWARD

The life insurance industry proudly serves 75 million American families as they prepare for a secure financial future. The products we provide to employers of all sizes give businesses more stability and certainty, thus fueling economic growth. In fact, the life insurance industry pays out \$1.5 billion every day. The industry is also a cornerstone of the U.S. economy, generating 2.5 million jobs and investing \$5.2 trillion to support economic expansion.

Our goal is to improve and expand families' financial and retirement security. Government should be looking to partner with the life insurance industry, not penalize its companies, agents, advisors, and consumers. Together—with smart regulations and laws, including tax rules—we can continue to provide the tools Americans need for a secure future.

OVERVIEW

- Our nation's public policies should continue to encourage families and businesses to plan for the future, save for retirement, and protect against financial risks.
- Instead, the new tax regime outlined in the discussion draft released in February creates more barriers to financial and retirement security for Americans.
- The proposed new taxes on life insurance companies effectively impose new taxes on life insurers' products, making it more difficult for companies, agents, and advisors to provide reliable and affordable options for families and businesses alike. The taxes would undermine the nation's critical need for long-term planning and financial protection.
- The proposed taxes on retirement savings and changes to contribution and distribution rules create significant impediments to employers' willingness to provide retirement savings plans and Americans' retirement security.
- Unlike other companies that can adjust prices as necessary, life insurance companies' business models require that insurance contracts be priced when issued to cover commitments that extend over decades. Therefore, long-term stability in tax law is essential for life insurers to ensure that policyholders' promises will be met.
- The discussion draft extends the active financing exception for income from the active conduct of life insurance business for five years. Tax reform should exempt active insurance income from subpart F on a permanent basis.

The following is a brief outline of how the new tax regime would affect the life insurance industry and its consumers.

INSURANCE RESERVE DEDUCTIONS

Reserves are the amount that insurance companies must set aside by law to be able to pay future policy claims, taking into account the risk characteristics of each policy. Reserves are the amount required—together with future premiums and interest—to pay future claims.

- The tax code generally provides that all corporate taxpayers compute their taxable incomes by subtracting allowable tax deductions for ordinary and necessary business expenses from their gross income. This approach reflects good tax policy by facilitating the proper matching of a corporation's income and expense amounts.
- Life insurers follow these same general rules as other corporate taxpayers in computing their taxable income. However, since policyholder premiums are included in life insurance companies' gross income, life insurers also are allowed an insurance reserve deduction for amounts needed today to meet future policyholder obligations.
- An insurance reserve deduction is a long-standing, well-vetted component of the tax law that is both necessary and appropriate to ensure an accurate matching of a life insurer's income and related expenses, and to clearly reflect the taxable income of life insurers.
- The formula in the tax code for computing the insurance reserve deduction uses reserves required by state regulatory accounting rules ("annual statement reserves"). The tax code then prescribes an adjustment to those legally-required annual statement reserves if the applicable federal interest rate is higher than the interest rate used to compute the annual statement reserves. This adjustment often causes a life insurer's tax reserves to be lower than its annual statement reserves.
- Any further cutback in life insurance companies' tax reserve deduction, such as the proposal in the Camp Tax Reform Discussion Draft to dramatically increase the interest rate used to discount reserves for tax purposes, would be contrary to sound tax policy and would result in a significant reduction in value to current and future policyholders.

DEFERRED ACQUISITION COST ("DAC") TAX

Policy acquisition expenses, such as commissions, are expenses incurred in the sale of life insurance company products. For statutory accounting purposes, such costs are immediately expensed and not capitalized.

- The tax code generally provides that all corporate taxpayers compute their taxable incomes by subtracting allowable tax deductions for ordinary and necessary business expenses from their gross income. This approach reflects good tax policy by facilitating the proper matching of a corporation's income and expense amounts.
- Most corporate taxpayers are entitled to a current tax deduction for selling expenses.

- Unlike other corporate taxpayers, life insurers have been required since 1990 to capitalize and amortize over a 10-year period a portion of their tax deduction for expenses associated with writing new business. This postponement of a life insurer's tax deduction for its acquisition expenses is known as the DAC tax.
- The DAC tax essentially results in an addition to a life insurer's current taxable income based on an arbitrary percentage of its premium income—a proxy for the costs associated with writing life insurance and annuity contracts. The Camp Tax Reform Discussion Draft proposal would radically increase these arbitrary percentages.
- The DAC tax is unfair and should not be made even more onerous.
- The Camp Tax Reform Discussion Draft proposal to increase the DAC tax would drain value from the financial and retirement security products that 75 million American families have come to rely on, make life insurers' products more expensive, and hinder Americans' efforts to protect their families' financial security and save for retirement.
- We object to changes in the DAC tax that would disrupt the competitive marketplace enjoyed by consumers.

DIVIDENDS-RECEIVED DEDUCTION (DRD)

The tax code ensures against the double taxation of corporate earnings through a tax code provision called the DRD.

- All corporate taxpayers are allowed the DRD, which generally provides corporate shareholders with a partial exclusion (70%) of the dividend amount from income tax.
- All corporate taxpayers also generally are permitted to exclude tax-exempt interest on municipal bonds they own.
- Life insurance companies are subject to an additional set of rules, called "proration," that further limit their DRD and exclusion of tax-exempt interest.
- It has been long-standing policy that life insurers be subject to these rules for calculating their DRD and the exclusion of tax-exempt interest.
- The Camp Tax Reform Discussion Draft would reduce life insurance companies' DRD and tax-exempt interest even further by inappropriately changing the proration calculation.
- The Camp Tax Reform Discussion Draft proposal is based on a misguided notion that life insurers' DRD and exclusion of tax-exempt interest under current law represents more than the insurers' interest in the dividends and interest.
- Reducing insurers' DRD and exclusion of tax-exempt interest would drain value from the financial and retirement security products that 75 million American families have come to rely on, making life insurers' products more expensive and hindering Americans' retirement savings.

COMPANY USES OF LIFE INSURANCE

Businesses often purchase life insurance to keep the company running and to protect jobs after the death of an owner or key employee. They also use life insurance to finance employee benefits, including important health, disability, survivor, and supplemental retirement benefits. This use of life insurance is commonly referred to as COLI.

- In the current fiscal environment, protecting jobs and employee benefits has never been more important and COLI plays a key role in both of these functions.
- A COLI policy can only be issued to a company on employees for whom they have an insurable interest.
- Congress has consistently reaffirmed the benefits of COLI, and did so again in 2006 on a broad, bi-partisan basis after three years of study.
- The 2006 legislation confirmed that COLI should not be taxed as long as best practices are followed—that policies be taken out only on officers, directors, and highly-compensated employees and that companies notify individuals and receive their informed consent. The 2006 law ensures compliance through IRS enforcement.
- The additional limitations on COLI proposed by the Camp Tax Reform Discussion Draft are unnecessary and inappropriate, and COLI should be seen for what it is: a way for responsible employers to protect jobs and benefits.

RETIREMENT SECURITY

The private retirement system provides a robust and growing foundation for millions of Americans' retirement security through defined contribution plans, such as 401(k)s, as well as IRAs, individual annuities, and supplemental retirement savings. New taxes and limits on retirement savings would weaken financial security. Taken together, the proposed taxes and new limitations on retirement contributions would discourage small business plan sponsorship and reduce participant savings.

- **The discussion draft proposes new taxes on retirement contributions.** For individuals in the new 35% bracket, it would impose a 10% surtax on both employer and employee contributions when made to a retirement savings plan.
- With no adjustment given for taxes already paid, retirement savings would be taxed a second time (at full ordinary income rates) when distributed from the plan during retirement and add unnecessary complexity, particularly on non-vested employer contributions.
- This tax treatment would make dedicated retirement savings plans less advantageous in comparison to other savings vehicles, particularly for small business owners who are not likely to sponsor a retirement plan at their business without strong incentives to outweigh the costs of implementing a plan.
- **The proposal would limit the amount Americans are able to save for retirement.** The discussion draft also proposes to freeze the inflation adjustments for the limits on annual contributions to retirement plans until 2024.
- It would have a significant and negative cumulative impact on individuals' ability to save for their retirement. If the past decade's adjustments were extrapolated forward, by 2024, the deferral limit would be nearly \$4,500 less in today's dollars.
- **The proposal ignores the importance of tax deferral.** It would also limit the amount of pre-tax deferrals to 50% of the annual cap (or \$8,750 in 2014), with the rest required to be contributed on a Roth/post-tax basis.
- This proposal disregards the importance of up-front tax deferral in encouraging savings and small business plan sponsorship.
- Reducing tax deferral incentives will likely have the greatest consequence on decision-makers, who are most likely to have high current tax rates and be less incentivized to offer a plan and individuals nearing retirement, who have less time to make up savings shortfalls.
- **The proposal would severely limit the use of nonqualified supplemental benefits.** These are vital for employees to save for retirement and are already subject to strict rules and regulations governing their use.
- The cumulative effect of the tax increases on life insurers will make life insurance products—such as annuities—less affordable for individuals who do not have a workplace plan, those who want to supplement their savings, and individuals seeking retirement income for life.

SUMMARY

The tax regime outlined above does not take into account the tax increases that would be levied broadly on corporations under the new proposal. These provisions and the new "bank tax" would compound the negative impact on life insurers and consumers.

The new taxes on life insurance companies, products, and retirement savings would adversely impact the ability of families and businesses to protect against risk and plan for their long-term financial security. These taxes would affect the 75 million American families who today rely on life insurers' products—in addition to our future customers. The new taxes would increase the cost of products and curb their use, thereby undermining the critical need for long-term savings and financial protection.

POLICY INQUIRIES CONTACT

Morris Goff, Vice President, Federal Relations, Tax
MorrisGoff@acli.com, 202-624-2013

Alane Dent, Vice President, Federal Relations,
Taxes & Retirement Security
AlaneDent@acli.com, 202-624-2112

MEDIA INQUIRIES CONTACT

Jack Dolan, Vice President, Media Relations
JackDolan@acli.com, 202-624-2418

Company Owned Life Insurance (COLI):

Businesses Use Life Insurance to Manage Risk, Protect Jobs, and Ensure Benefits

Overview

- 75 million American families rely on life insurers' products for their financial and retirement security.
- Our nation's public policies should continue to encourage families—and businesses—to plan for the future and protect against financial risks.
- Changing the tax treatment of COLI would make it harder for businesses to use life insurance to provide certainty for their employees.
- It is unwise and unwarranted to change long-established tax policy that allows insurers to provide long-term guarantees and financial security.

Business Use of Life Insurance

- Businesses of all sizes often purchase life insurance to keep businesses running and to protect jobs after the death of an owner or key employee. They also use life insurance to finance employee benefits, including important survivor and supplemental retirement benefits.
- In the current fiscal environment, protecting jobs and employee benefits has never been more important and COLI plays a key role in both of these functions.
- Congress has consistently reaffirmed the treatment of COLI, and did so again in 2006 on a broad, bi-partisan basis after three years of study.
- The 2006 legislation confirmed that COLI should not be taxed as long as best practices are followed: (1) policies can be taken out only on officers, directors and highly compensated employees; (2) prior approval must be obtained before a policy is issued; and (3) policies can be issued only on employees with whom the company has an insurable interest.
- No additional limitations are needed or appropriate and COLI should be seen for what it is: a way to manage risk, protect jobs, and ensure benefits.

In Summary

Life insurers offer the products and services that make families more financially secure and businesses more stable. Tax proposals that target life insurers—or the businesses and families that rely on their products—are exactly the wrong course for policy-makers to take. Policy-makers should not take actions that would make financial and retirement security products and services more expensive and less available.

Capital Fuels Financial Security

Federal income tax increase on all industries

1%

The Camp tax reform discussion draft would raise federal income taxes on all industries by 1 percent over 10 years. However, federal income taxes on the life insurance industry would increase by 26 percent.*

Federal income tax increase on the life insurance industry

26%

These extraordinary and unwarranted new taxes would burden families, businesses, and the economy.

**EY analysis of Joint Committee on Taxation revenue estimates*

Proposed Tax Increases Would Hurt Families

The taxes proposed in the 2014 Camp discussion draft would harm the millions of American families and businesses that rely on life insurers' products for financial protection and retirement security.



The new taxes on life insurance companies will directly affect the products that life insurers provide to help American families meet their financial and retirement security needs.

Higher taxes will constrict the capital that life insurance companies need to: (1) comply with state regulations; (2) fulfill their long-term contractual obligations and guarantees; and (3) develop new and affordable products. To respond to the pressure on capital:

- 1 consumer benefits may be reduced,
- 2 prices may be increased, and
- 3 some products may no longer be available.

Each of these actions would harm families by damaging the financial safety net life insurers provide.

Tax reform must not make it harder for families and businesses to plan for the future, save for retirement, and protect against financial risks.

Proposed Tax Increases Would Hurt the Economy

The taxes proposed in the 2014 Camp discussion draft would shrink the industry's ability to make the investments that spur economic growth and job creation.

LIFE INSURERS:

- Have **\$5.2 trillion** invested in the U.S. economy.
- Pay out **\$1.5 billion** everyday.
- Generate **2.5 million** jobs.

PROPOSED TAXES ON FINANCIAL AND RETIREMENT SECURITY WOULD HURT CONSUMERS

Tax proposals like those in the 2014 Camp discussion draft would have a very negative impact on the millions of American families and businesses that rely on life insurers' products for financial and retirement security. These taxes would result in a marketplace with fewer choices, and products that are more expensive or have reduced benefits—making it more difficult for Americans to create their own financial safety net.

This paper explains how an increase in the DAC tax would negatively affect companies, products, and consumers.

DEFERRED ACQUISITION COSTS (DAC)

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- The tax code generally provides that all corporate taxpayers compute their taxable incomes by subtracting allowable tax deductions for ordinary and necessary business expenses from their gross income. This approach reflects good tax policy by facilitating the proper matching of a corporation's income and expense amounts.
- Most corporate taxpayers are entitled to a current tax deduction for selling expenses.
- Unlike other corporate taxpayers, life insurers have been required since 1990 to capitalize and amortize over a 10-year period a portion of their tax deduction for expenses associated with writing new business. This postponement of a life insurer's tax deduction for its acquisition expenses is known as the DAC tax.
- The DAC tax essentially results in an addition to a life insurer's current taxable income based on an arbitrary percentage of its premium income—a proxy for the costs associated with selling life insurance and annuity contracts.
- The DAC tax is unfair and should not be made even more onerous through proposals that would radically increase these arbitrary percentages.
- Any proposal to increase the DAC tax would drain value from the financial and retirement security products that 75 million American families have come to rely on, make life insurers' products more expensive, and hinder Americans' efforts to protect their families' financial security and save for retirement.
- We object to changes in the DAC tax that would disrupt the competitive marketplace enjoyed by consumers.

SUMMARY

Congress should continue to encourage families and businesses to plan for the future, save for retirement, and protect against financial risks.

CONTACT: Morris Goff, Vice President, Federal Relations, Tax; MorrisGoff@acli.com, 202-624-2013

American Council of Life Insurers | 101 Constitution Avenue, NW, Suite 700, Washington, DC 20001-2133
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This paper explains how proposals to further limit life insurers' DRD would negatively affect companies, products, and consumers.

DIVIDENDS-RECEIVED DEDUCTION (DRD)

The tax code ensures against the double taxation of corporate earnings through a tax code provision called the DRD.

- All corporate taxpayers are allowed the DRD, which generally provides corporate shareholders with a partial exclusion (70%) of the dividend amount from income tax.
- All corporate taxpayers also generally are permitted to exclude tax-exempt interest on municipal bonds they own.
- Life insurance companies are subject to an additional set of rules, called "proration," that further limits their DRD and exclusion of tax-exempt interest.
- It has been long-standing policy that life insurers be subject to these rules for calculating their DRD and the exclusion of tax-exempt interest.
- Any proposal to further limit life insurance companies' DRD and exclusion of tax-exempt interest by changing the proration calculation would be inappropriate.
- Proposals to further limit life insurers' DRD are based on a misguided notion that the DRD and exclusion of tax-exempt interest under current law represents more than the insurers' interest in the dividends and interest.
- Reducing insurers' DRD and exclusion of tax-exempt interest would drain value from the financial and retirement security products that 75 million American families have come to rely on, making life insurers' products more expensive and hindering Americans' retirement savings.

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This paper explains how increasing the tax on life insurance companies by further limiting reserve deductions would negatively affect companies, products, and consumers.

LIFE INSURANCE RESERVE DEDUCTIONS

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- Any further cutback in life insurance companies' tax reserve deduction, such as the proposal in the Camp discussion draft to dramatically increase the interest rate used to discount reserves for tax purposes, would be contrary to sound tax policy, and would result in a reduction in value to policyholders.
- Unlike other companies that can adjust prices as necessary, life insurance companies' business models require that insurance contracts be priced when issued to cover commitments that extend over decades. Therefore, long-term stability in tax law is essential for life insurers to ensure that promises made to policyholders will be met.

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Congress should continue to encourage families and businesses to plan for the future, save for retirement, and protect against financial risks.

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Facts About the U.S. Life Insurance Industry

Providing Jobs

- The life insurance industry generates approximately 2.5 million jobs in the U.S., including direct employees, those who sell life insurance products, and non-insurance jobs supported by the industry.
- The U.S. life insurance industry is made up of nearly 850 companies with sales and operations across the country.

Protecting Families

- 75 million American families depend on the life insurance industry for financial and retirement security.
- 144 million individual life insurance policies were in force at the end of 2013, which includes \$19 trillion worth of life insurance protection through individual policies and group certificates.
- The life insurance industry pays out \$1.5 billion every day through payments from life insurance, annuities, long-term care insurance, disability income insurance, and other types of insurance products.
- More than 1 out of every 6 dollars of Americans' long-term savings is in permanent life insurance and retirement annuities.

Investing in the Economy

- The life insurance industry has \$5.6 trillion invested in the U.S. economy, making it one of the largest sources of investment capital in the nation.
- Life insurers invest in American business for the long-term. More than one-third (37%) of general account bonds held by life insurers had a maturity of more than 20 years at the time of purchase. More than two-thirds had a maturity of more than 10 years.
- Life insurers are the largest institutional source of bond financing for American businesses, holding 20% of all U.S. corporate bonds.
- Of the \$727 billion in government and agency bonds held by life insurers, the overwhelming majority, \$690 billion, were in long-term obligations.
- Life insurers provide long-term capital to the commercial mortgage market, directly financing more than \$286 billion, or nearly one-eighth, of U.S. commercial mortgages.

About ACLI

- ACLI represents approximately 300 member companies operating in the United States and abroad.
- ACLI members represent more than 90% of industry assets and premiums. Members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance.

Sources: ACLI calculations based on National Association of Insurance Commissioners (NAIC) 2013 annual statement data; Federal Reserve Board's 2013 *Survey of Consumer Finances* and 2013 Flow of Funds data; 2012 Ernst & Young data; and 2013 Census data

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