A FairTax℠ White Paper

The FairTax treatment of insurance

The primary purpose of insurance is to mitigate risk, either on property or people. While life and annuity insurance products have some tax benefits under the current tax system, the FairTax either continues these benefits or improves them.

> **Under the current system, the entire premium is paid with after-tax dollars. Only the "insurance" component of the premium is taxed dollars under the FairTax.**
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> **Under the current system, insurance cash values grow tax deferred. They grow tax free under the FairTax.**
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> **Under the current system, cash values are taxed upon withdrawal. They are withdrawn tax free under the FairTax.**
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> **Under the current system, benefits received are tax free today (if the premium was taxed). They are paid tax free under the FairTax.**

Overview

Under the current system, benefits received are tax free because the premiums were taxed and taxing the benefit would be considered double taxation. Under the FairTax, the benefit received is also tax free, but the proceeds are taxed as spent. Section 206 of the FairTax legislation (HR 25) provides a credit to prepay these taxes. The insurance credit increases the benefit paid out by the tax rate, thereby avoiding double-taxation (see examples that follow).

Under the FairTax, the costs to deliver insurance products to consumers drop as the embedded corporate income tax, employer payroll taxes, and compliance costs are removed. Consumers receive their whole paychecks as a result, ending income tax and payroll tax withholding. This means pre-tax premiums are lower and the insured have more money in their pockets with which to pay them.

Boston University economist Dr. Laurence Kotlikoff estimates the shift to consumption taxation raises the stock of U.S. capital by at least 29 percent (potentially by as much as 49 percent) and U.S. living standards by at least seven percent and potentially by as much as 14 percent.[1] With a robust economy and more Americans at work the need for insurance and the ability to buy it will increase, providing tremendous growth for the insurance industry.

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[1] Kotlikoff, Laurence J., "Replacing the U.S. Federal Tax System with a Retail Sales Tax: Macroeconomic and Distributional Impacts," December, 1996.

The simplest way to understand the treatment of insurance under the FairTax is to compare it to the current system. When purchased for business purposes under the FairTax, both the premiums and the consumption of the benefit are treated as tax-free business inputs. Therefore, the following comparisons address insurance purchased for personal use.

Property/casualty insurance

Today, there are no tax benefits for purchasing property and casualty insurance (unless as a business, where it is deductible as a business expense). Like other services, the tax system embeds its cost in the price of the premiums. Under the FairTax, P&C carriers' costs are reduced substantially as the income tax, payroll tax, and compliance costs are removed from pricing. This reduction will likely be passed forward to consumers and consumers will have more income in their pockets to pay premiums.

The premium is subject to the FairTax if sold to a consumer. The benefit is received tax free and includes a credit to prepay taxes that are due when consumed. For example, if the consumer had storm damage to his house and received a $5,000 check to get his roof repaired, he would be entitled to an insurance credit of $1,494 to pay the FairTax when he spent the $5,000 on the roof repairs. Insurance purchased for business purposes is not taxed, e.g., to insure a place of business, business equipment, etc.

Life insurance

Term life insurance is usually preferred for short-term needs (less than 20 years) and creates no cash value. Whole life, universal life, and variable life insurance generate cash values and are usually preferred for long-term insurance needs. The FairTax does nothing to change the relative value of each. From a tax perspective, the FairTax treats both term and cash value life insurance as well as or better than the current system does.

Premiums:

- Current system – The entire premium is paid with after-tax dollars, whether term or cash value.
- FairTax – Only the "term" component of a premium is taxed. The "investment" component of the premium being invested in a cash value policy will not be taxed under the FairTax.

Cash value (if any):

- Current system – Cash values grow tax deferred, and when withdrawn the cash value comes out on a "principal first" basis. Any amount above the principal is taxed as ordinary income.
- FairTax – Neither the principal nor the interest is taxed while accumulated or when withdrawn. They only become taxable if the owner chooses to use them to purchase new goods or services. Those goods then purchased should be less expensive due to the removal of embedded taxes.

Death benefit:

- Current system – A death benefit is income tax free, but subject to estate taxes unless held in an irrevocable trust and certain rules are followed.
- FairTax – The death benefit is tax free and the beneficiary receives a credit equal to 23 percent of the benefit to prepay any sales taxes due when spent. No estate taxes are due.

For example, under the current system a person purchasing a $500,000 term policy system for $50 a month does so with after-tax dollars. Assuming this individual is in the 25 percent marginal income tax bracket (and including employee payroll taxes of 7.65 percent), he/she would need to earn $74 to have the $50 necessary after taxes to pay the premium. Since taxes were paid on the premium, at their death the death benefit would be received income tax free (but possibly subject to the estate tax).

Under the FairTax, if that individual earns that same $74, all of it is available to pay the premium. For the same $500,000 term policy, the $50 premium now costs $65 ($50 plus $15 in taxes) and possibly less as the insurance company passes on any savings from the removal of embedded taxes and compliance costs. This leaves them with at least an additional $9 in their pocket to use as necessary or to increase their insurance. For example, a 50 year old male could purchase a $500,000 ten-year level premium term policy for $49.38. Paying a monthly premium of $59 would purchase just over $612,000, an increase in coverage of $120,000 extra insurance – a 22 percent increase.

The FairTax is on consumption, not income, so of course there is no tax on the death benefit when it is received. However, because the death benefit is taxed when used to buy retail goods and services, the FairTax provides a credit equal to the FairTax rate times the death benefit. Since the premium payments are taxed, the credit prevents double taxation by prepaying the tax.

Annuities

Under current law, annuities can be sold as qualified plans (IRAs, 401 (k)s, etc.) or non-qualified. Today deposits/premiums to non-qualified annuities are made with after-tax dollars. Cash values grow tax deferred. Withdrawals are taxed as ordinary income, and if withdrawn before age 59 1/2 a 10-percent penalty applies. The early withdrawal penalty applies whether it is qualified or not.

Annuities are one of the few non-qualified investments you can buy where growth is tax deferred. Insurance companies feel this gives them a competitive advantage. The downside is that gains are taxed as ordinary income when withdrawn, while a more traditional non-qualified investment such as a mutual fund would receive more favorable capital gains treatment, at least in part.

Annuities also have higher costs than other investments. These extra costs are for administration and protection benefits. These benefits can be in the form of a guaranteed minimum death benefit or living benefits. Typically, this base charge costs 1.5 percent of the annuity's value each year, which offsets any benefits of tax deferral unless the guarantees are important to the client. The charge can be higher if enhanced death and living guarantees are added.

Since there is no tax difference between an annuity and other investments bought as part of a qualified retirement plan (deposits to both are usually deductible), cash values grow tax deferred and withdrawals are taxed as ordinary income. The comparison here will only consider non-qualified annuities.

Premiums:

- Current system – The premium is paid with after-tax dollars and is not deductible.
- FairTax – In the case of annuity premiums, the FairTax treats them as it does all other forms of investment and does not tax them, i.e., premiums are purchased with pre-tax dollars. The consumer also has increased take-home pay to invest. Any service charges associated with the annuity (typically 1.5 percent) are taxed, but these costs will be lower due to the removal of embedded income/payroll taxes in the cost of doing business.

Cash value:

- Current system – Accumulations are tax deferred. When withdrawn, cash values are taxed as ordinary income. This is generally at the highest tax bracket based on the consumer's income. If these withdrawals are made prior to age 59 1/2, there is also a 10 percent federal penalty.
- FairTax – Accumulations are tax free. Withdrawals are also tax free. Pre-tax prices of goods and services purchased with the proceeds should be less expensive due to the removal of embedded costs and the consumer will have greater disposable income to make those purchases.

Death benefit:

- Current system – At death, any gains in cash value are not eligible for a "step-up" in basis and are taxed as ordinary income to the beneficiaries. This includes the value of any "benefits" added to the annuity that result in additional gains above the cost basis.
- FairTax – None of the proceeds are taxed at death.

Health insurance

As a preamble to the discussion of how the FairTax affects health insurance, it is important to note that the FairTax taxes the retail purchase of all goods and services, including health care services. While permitting no exemptions, the FairTax benefits Americans through a monthly universal prebate[2] which ensures that each family unit can consume tax free at or beyond the

[2] The monthly prebate check is calculated by multiplying the FairTax rate times the annual poverty level spending which is published annually by the Department of Health and Human Services and divided by twelve. Poverty level spending represents what it costs families of varying household size and composition to buy their necessities. The annual poverty level spending amount is based on the Department of Health and Human Services poverty guidelines plus an additional amount to eliminate the marriage penalty.

poverty level, with the overall effect of making the FairTax progressive in application. Under the FairTax, all Americans consume what they see as their necessities of life free of tax. This approach is more efficient than trying to exempt certain categories of goods and services and much less subject to lobbying for special treatment.

- Current system – Premiums for health insurance are treated differently, depending on who purchases the insurance. If you purchase insurance as an individual, it is paid for with after-tax dollars and is generally not deductible. If your employer or the government buys insurance on your behalf, the premiums are deductible for the company and are not taxable to you. If you are paying part of the premium for insurance through your employer, the premium is not deductible unless your employer establishes a Section 125 Plan, in which case your portion is paid for with pre-tax dollars, thus reducing your future Social Security benefit. Your cost for services and medicine above what the insurance company pays is paid for with after-tax dollars unless you use an itemized tax return, in which case you can only deduct those expenses exceeding 7.5 percent of your adjusted gross income.

  According to the American Association of Physicians and Surgeons, the greatest problem in the health care industry affecting costs is the lack of a "natural market." Because of the tax preferences in the income tax code, almost all health care is purchased by employers and the government. This removes flexibility, control, and cost awareness from the ultimate consumer, increasing usage and costs for everyone.

- FairTax – The general premise of the FairTax is to tax every new good or service one time. So when you purchase health insurance, your premiums are taxed, but the charges billed to the insurance company by the doctor are not taxed. (Taxing both premiums and benefit payments would result in double taxation.) If the insurance benefit is paid directly to you, it includes the insurance credit to prepay any taxes due as the benefit is spent.

  If you purchase health care services directly from the doctor (co-pays, deductibles) the charges are taxable. Of course, as noted above, the doctor's cost of doing business is significantly reduced, thereby allowing for lower pre-tax charges.

  From the doctor's perspective, the FairTax removes the cost of payroll taxes, income taxes, self-employment taxes, the cost of administering income tax withholding and payroll tax deductions for his/her employees, and personal income tax, payroll tax, and compliance costs. The doctor has to collect the FairTax only on direct payments for services by patients, and remit the taxes collected on a monthly or quarterly basis depending on volume. He/she retains one-quarter of 1 percent of the amount collected for their efforts.

  It makes no difference whether a company or an individual purchases the health insurance; the treatment is the same. This helps to create a natural market for health insurance and restore competition.

To sum up, the benefits of the FairTax to the insurance industry and consumers:

1. The pre-tax cost of insurance should drop as embedded taxes and compliance costs are removed.
2. The average American takes home their whole paycheck.
3. Only the risk component of cash value life insurance is taxed.
4. Cash values of both annuities and life insurance contracts grow and can be withdrawn tax free.
5. A credit insures that all insurance benefits are consumed tax free.
6. Death benefits are both income and estate tax free and include a credit to insure they aren't taxed when spent.
7. Health insurance benefits are tax free.
8. Natural markets are restored to the purchase of health insurance, helping to control and even lower future health care costs.

What is the FairTax Plan?
The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?
FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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