American Academy of Actuaries
Essential Elements
Making complex public policy issues clear

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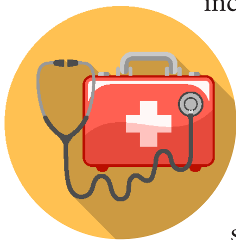
Tax Treatment of Pensions and Insurance Protections

The U.S. tax code, for public policy reasons, is deeply interwoven with provisions that help individuals acquire insurance protections and retirement security, and help businesses insure against risk. Employee health and pension benefits, individual health insurance, annuities and life insurance, and property/casualty lines of insurance are all interconnected with and affected by existing tax policies.

Insurance and pensions have a unique purpose—to secure individuals against unforeseen events and preserve resources in retirement through the pooling of risk. Together with income, investments, and retirement savings, insurance plays a critical role in Americans' economic well-being. Each type of insurance and retirement plan is governed by unique tax provisions that can help encourage individuals to mitigate risks they may not be able to afford or save for on their own.

Select Tax Treatments of Insurance and Pensions

- **Health Insurance.** Typically, employees can exclude premiums they pay for health insurance from their taxable income, along with the value of any benefits they receive. For employers, premiums paid for health insurance and any health care claims paid are deductible. Similarly, self-employed individuals are allowed to deduct a certain amount of medical, dental, and long-term care premiums from their income taxes.



The Affordable Care Act (ACA) also created tax credits for premiums paid by low- to middle-income individuals (defined as 100-400 percent of the federal poverty level) who do not have employer-sponsored health insurance or who are not eligible for Medicaid. In addition, the ACA introduced a small business health care tax credit to assist employers with 25 or fewer full-time employees earning $50,000 or less on average.

Additional tax rules govern private disability and long-term care insurance. For disability insurance, benefits on plans paid for by employers are taxable, while benefits on plans paid with after-tax dollars by individuals are tax-free. For qualified long-term care insurance, premiums paid by a policyholder are generally tax-deductible.

- **Life Insurance.** Unlike most health insurance and retirement plans, individual premiums for life insurance are not tax-deductible. (Specific group term rules exist for employer-paid premiums, the first $50,000 of coverage of which is not considered taxable income.) Life insurance benefits paid upon the death of a policyholder are not subject to income tax. Earnings on life insurance policies are only subject to tax in the event that a policy lapses or a policyholder surrenders a life insurance policy with a value greater than the premiums paid.

Annuities, which ensure lifetime income in retirement, also have special tax rules. In the case of deferred annuities, earnings are allowed to accumulate tax-free, and only the portion of payments that come from earnings on the annuity are taxable. In the case of immediate annuities purchased with after-tax dollars, only the earnings above the value of the policyholder's initial contribution are subject to taxation.

- **Property/Casualty Insurance.** Uninsured property/casualty losses are generally deductible from taxable income. Retroactive deductions on losses occurring in federally declared disaster areas can also be made in the year following the disaster.

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For individuals receiving workers' compensation benefits, taxes are generally not paid on benefits.

- **Retirement Savings and Pensions.** Defined contribution plans sponsored by employers are generally tax-deferred, meaning that enrollees can contribute a portion of their paychecks pre-tax and pay taxes only when they withdraw amounts from such plans. Similarly, for employers, contributions to employees' plans are tax-deductible. Under defined benefit plans, which employees generally do not contribute to, benefits received are subject to income tax. Other retirement savings vehicles (e.g., Roth IRAs) are not subject to this common tax treatment. Instead, contributions to these plans are paid with after-tax dollars, but withdrawals are not subject to taxation.

Low- to middle-income taxpayers are also eligible for the Retirement Savings Contributions Credit (known as the Savers Credit), which provides an income-based tax credit for retirement plan or IRA contributions.

Tax-Deferred Retirement Plans: Illustrating Public Policy Considerations

Tax-deferred defined contribution plans are among the most common retirement plans offered by employers. According to the Budget of the U.S. Government, 2018, Analytical Perspectives, such plans accounted for $61.8 billion of federal tax expenditures in 2016. Yet this same tax treatment may help encourage employers to sponsor and contribute to retirement plans. Similarly, allowing employees to deduct retirement contributions from their taxable incomes may encourage them to set aside savings for retirement.

Policymakers considering revisions to the tax treatment of tax-deferred retirement accounts should weigh several public policy implications. For example, although converting such accounts to accounts with post-tax contributions and tax-free withdrawals may result in federal revenue gains over the short term, these gains could be offset in the long term by corresponding expenditures as individuals begin to make withdrawals in later years.

There are many possible consequences of tax reform. For example, changes to the tax treatment of retirement plans could also increase retirement income disparities between lower and higher earners. In addition, because many individuals may have a higher tax rate in their working years than during retirement, a plan with post-tax contributions may leave them with fewer tax savings than under a tax-deferred plan. Finally, eliminating the option to make tax-deferred contributions to retirement accounts could make such accounts less desirable, and potentially reduce the number of individuals accumulating critical retirement savings.

Tax Policy: A Question of Trade-Offs

Changes to the tax code can have critical economic impacts, such as on gross domestic product (GDP), national savings, or income security. Consequently, policymakers seeking to revise the tax code must consider the potential policy implications of tax reform provisions.

Tax treatment of insurance and pension benefits can significantly affect their affordability, accessibility, and reliability. Changes to the tax code may affect insurance and retirement plans directly, through tax incentives, deductions, or deferrals, or they may occur unintentionally, as a result of corporate or individual tax rate changes.

Similarly, tax policy that focuses directly on insurance and retirement plans can have broader economic effects. For example, because insurance companies and retirement plans are very large purchasers of corporate and government debt, changes to their tax treatment could have significant effects on capital markets. In addition, because tax policies can encourage individuals to self-fund their risks through tax-favored insurance policies, tax policy revisions that lead individuals to forgo or lower contributions to retirement plans and annuities could ultimately increase reliance on social insurance programs, such as Social Security and Medicare, which themselves are supported largely by payroll taxes.