Life insurance income taxation

In brief

INCOME TAX TREATMENT OF LIFE INSURANCE

- Tax-deferred growth
- Tax-favored withdrawals
- Tax-free death benefit

TAX-DEFERRED GROWTH

- Gain due to growth in life insurance policies is generally not subject to current income taxation.
- The growth in life insurance policies owned by a C corporation might be subject to the accumulated earnings tax.

Tax-favored withdrawals

- Partial surrenders, surrenders of additions, and dividends received in cash are generally not taxed until they exceed basis (investment in the contract). However, distributions of cash during the first 15 years of a policy might result in taxation under the forced-out gain rule.
- Loans are generally not taxable.
- The complete surrender or lapse of a policy causes tax on any gain in the policy. Lapses of heavily loaned policies cause a “surrender squeeze” when the income tax due exceeds the amount available in the policy.
- Distributions from a life insurance policy that is a Modified Endowment Contract (MEC) comes out gain-first and is income taxed to the extent of gain in the policy.
- A loan from a MEC is treated as a distribution and triggers ordinary income tax to the extent of gain in the policy.
- A pledge or assignment of a MEC also triggers taxation to the extent of gain in the policy.
- Whenever there is a taxable distribution from a MEC – partial surrender, dividend, loan, pledging of policy, or complete surrender – the taxable portion of the distribution is also subject to an additional 10% penalty tax, unless the owner is age 59½, disabled, or takes substantially equal periodic payments over life expectancy.

(REV 0521)

Comparison of income tax treatment

Non-MEC v. MEC

	NON-MEC (normal life insurance)	MEC
Cash dividend	Tax free until basis recovered	Taxable*
Partial surrender	Tax free until basis recovered	Taxable*
Loan to pay premium	Not taxable	Taxable*
Loan from policy (or pledged or collaterally assigned)	Not taxable	Taxable*
Dividend to pay premiums	Not taxable	Not taxable
Use of paid-up dividend additions to pay premium	Not taxable	Not taxable
Death benefit	Not taxable	Not taxable

* Ordinary income tax is imposed to the extent of gain in the contract, and a 10% additional penalty tax could apply also. But if there is no gain, then there is no income tax nor is there a 10% penalty.

Tax-free death benefit

General rule

- The death benefit of a life insurance policy is generally received free of income tax.
- For a life insurance policy owned by a C corporation, the death benefit might be subject to the accumulated earnings tax.
- Also, employer-owned life insurance must satisfy notice and consent requirements to be income tax free.

Transfer-for-value rule

- If any interest in a life insurance policy is transferred for valuable consideration, the death benefit is generally income taxed. "Consideration" means cash or other consideration reducible to a money value (and might also include a mere promise from the transferee).
- Death benefit is income taxed to extent it exceeds basis.

Transfer-for-value exceptions

- Transfers to:
  - the insured,
  - a partner of the insured,
  - a partnership in which the insured is a partner,
  - a corporation in which the insured is an officer or shareholder, or
- Transfers where the transferee's basis is determined by reference to the transferor's basis. (This occurs in a number of situations, including transfers between spouses or incident to divorce.)
- These exceptions cannot be used in the case of a reportable policy sale.

Reportable Policy Sale

- A Reportable Policy Sale is the direct or indirect acquisition of an interest in a life insurance contract where the acquirer does not have a substantial family, business, or financial relationship to the insured. Internal Revenue Code (I.R.C.) § 101(a)(3).
- When a Reportable Policy Sale occurs, the acquirer notifies (1) the seller and the IRS of the purchase price for the life insurance contract and (2) the insurance company that a Reportable Policy Sale occurred. I.R.C. § 6050Y.
- At the death of the insured, the insurance company reports the death benefit and an estimate of Basis to the beneficiary and the IRS. I.R.C. § 6050Y.
- The Reportable Policy Sale rules are distinct from the transfer-for-value rule. There is good reason to believe that "indirect acquisitions" – for example, where a new owner buys into a business that owns a policy – do not trigger the transfer-for-value rule, but the law is not entirely clear on this point.

Transfer-for-value traps and solutions

- Gift of a policy with a loan **in excess of basis**. (Part gift/part sale).
  - **Problem.** Assumption of the loan by the transferee is valuable consideration. The transferee's basis is generally the greater of the transferor's basis or consideration paid (loan assumed). Because the loan is greater than the basis, carryover basis exception does not apply and the transfer-for-value rule is triggered.
  - **Solution.** Before the transfer, repay part of the loan so its amount is lower than basis.
- Transfer of policy from corporation to non-insured shareholders to fund a cross purchase buy-sell plan.
  - **Problem.** Transfer is for consideration, triggering the transfer-for-value rule.
  - **Solution.** Before the transfer, form a partnership including shareholders and insured.

Section 1035 exchange

Basics

A 1035 exchange is a tax-free exchange of an existing policy for a new one.

- Advantages of a 1035 exchange include:
  - No income tax of built-in gain;
  - Carryover of basis (especially where accumulated value is less than basis); and
  - Lump sum contributed to new policy will not create a MEC (although subsequent premiums on the new policy must be within the MEC seven-pay limit for the new policy, adjusted for the lump sum).

  Permissible exchanges are:

  - A life insurance policy exchanged for another life insurance, endowment policy, annuity, or long-term care insurance contract;
  - An endowment policy exchanged for an annuity contract or long-term care insurance contract; or
  - An annuity exchanged for another annuity or long-term care insurance contract.
- When exchanging life insurance for life insurance, the policy received in the exchange must generally be on the same insured (for example, a single life policy exchanged for second-to-die policy, or vice versa, does not qualify).
- Exchanges can involve different insurance carriers, different types of policies, or a different number of policies.
- MEC contracts exchanged via a 1035 exchange will retain their MEC status post-exchange.
- If money or property is received in the exchange, the money or property is treated as "boot" and income tax will be imposed equal to the lesser of the "boot" or the gain in the policy.

Loans

- A 1035 exchange of policies with loans may cause taxation:
  - Many insurers, including Northwestern Mutual, will not issue a new policy with a loan.
  - The elimination of a policy loan in a 1035 exchange is taxed as the receipt of money or property ("boot").
  - This triggers taxable income equal to the lesser of the loan or the gain in the policy.
  - The loan should be paid off or extinguished through a partial surrender before the 1035 exchange occurs. (Caution is advised with partial surrenders to avoid the forced-out gain rule and the step transaction doctrine.)

Miscellaneous facts

- **Premiums –** Premiums paid for life insurance are not deductible. If a business pays the premium for a policy owned by its employee, the business generally can deduct the premium amount as reasonable compensation (not as premium) and the employee recognizes income on that amount.
- **Interest on policy loans –** Generally no deduction is allowed for interest paid with respect to life insurance policy loans. There is an exception for business owned policies for interest on policy loans up to $50,000 per insured, if the insured is a key person and other requirements are met under I.R.C. § 264.
- **Transfer of policy for consideration –** Gain in a policy transferred for valuable consideration triggers income tax to the transferor. Examples of this include transferring a policy from a business to its employee, trading policies among business owners, and when a policy is gifted where the loan exceeds the policy's basis (it's treated as a sale for the loan amount). Additionally, the death benefit might be subject to income tax under the transfer-for-value rule.
- **Business-owned policy where beneficiary is not the business –** If a business owns a policy on the life of an employee and names the employee's spouse as beneficiary, the death benefit is treated as two transfers: (i) as if paid to the business as tax-free death benefit: and (ii) then paid to the employee's spouse, likely as taxable compensation. The death benefit could go to the spouse tax-free if the employee includes the cost of insurance in income each year under a split dollar plan.
- **Surrender squeeze –** Large loans on a policy can force it to lapse, which is a surrender and triggers income tax on any gain in the policy (gross value in excess of basis), even if there is little or no net value that the owner actually receives upon the lapse.
- **Change of insured –** Policy provision permitting the substitution of one insured for another. A change of insured is treated as a surrender of a contract and a purchase of a new contract. This is not a tax-free 1035 exchange.
- **Tax reporting –** Northwestern Mutual sends a Form 1099 to the IRS and the policy owner on most taxable distributions, including:
  - Surrender or lapse of a contract
  - Change of insured
  - Receipt of cash dividends in excess of basis
  - 1035 exchanges with "boot"
  - Loans or other distributions from MECs
  - Assignment of a MEC as collateral for a loan
  - Distribution which results in forced-out gain under I.R.C § 7702(f)(7)

Key words and phrases defined

- **Basis (investment in the contract) –** Gross premiums plus other consideration paid, reduced by amounts received tax-free. Gross premiums do not include the premium for extra benefits (for example, Waiver of Premium, Accidental Death, Additional Purchase Benefit).

- **Fair market value –** The fair market value of a life insurance policy is generally the following:
  - In *gift taxable* transactions, value generally is defined as: (i) for new policies, the total of premiums paid; (ii) for paid up policies, the replacement cost; and (iii) for existing policies with premiums still due, the interpolated terminal reserve plus unearned premiums. *See* IRS Form 712.
  - In *income taxable* transactions, value generally is defined as the higher of: (i) interpolated terminal reserve plus unearned premiums, plus expected dividends, or (ii) premiums plus earnings, minus reasonable charges. *See* Revenue Procedure 2005-25.
  - A policy's value is generally decreased by any policy loans.

- **Forced-out gain –** Under I.R.C. § 7702(f)(7), gain in the policy is taxable upon certain distributions (such as partial surrenders or surrender of additions) during the first 15 years of the contract, even if the distribution is less than basis. This rule is not triggered by loans, and it usually results from substantial distributions on cash-rich policies.

- **Gain –** Gross value minus basis. When taxable, gain results in ordinary income.

- **Lapse –** Termination of the policy through depletion of value. Taxed as surrender.

- **Life insurance –** Policy meeting either the "cash value accumulation" test or both the "guideline premium" and "cash value corridor" tests found in I.R.C. § 7702.

- **Material change –** A change to a life insurance policy that causes the policy to be retested under the MEC 7-pay test, including the following:
  - Purchase of additional insurance
  - 1035 exchange
  - Change of insured
  - Term conversion
  - Addition of "Qualified Benefits" (waiver of premium, additional purchase benefit, accidental death benefits)
  - Change in type of policy
  - Certain increases in death benefit

- **Modified Endowment Contract (MEC) –** Life insurance policy issued or "materially changed" after June 20, 1988 which fails the 7-pay test in I.R.C. § 7702A.

- **Partial surrender –** Withdrawal of cash from the policy by surrendering a portion of the policy (often the policy's paid-up dividend additions).

- **Surrender –** Intentional termination of policy with policyowner receiving net accumulated value.