

## **Part V Life Insurance and Taxation**

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The taxation of life insurance is a complex issue, because the product may be affected by federal income, corporate, gift and estate taxes. State taxes are usually limited to premium taxes, calculated into the gross premium paid by the consumer, and have relatively little direct impact. Of course, Congress is always altering the Internal Revenue Code, so federal tax rules are always subject to change.

### **The “Life Insurance” Tests:**

The most important factor in determining the tax effect on a life insurance product is its status as “life insurance” within the Internal Revenue Code. In reaction to abuses 20 years ago, Congress created two tests that all products must pass—the cash value accumulation test and the guideline premium and corridor test. A policy qualifies as life insurance if it meets either one.

The testing is done by the issuing company, and all approved products from admitted companies pass one test or the other.

The cash value accumulation test, most usually applied to whole-life type policies, limits the cash value to the single net premium necessary to fund the actuarial death benefit.

The guideline premium and corridor test, a 2-pronged test applied to universal life-type policies, limits the total premium that can be paid in at any one time and establishes a minimum ratio of death benefit to cash value at all times.

These rules are contained in Section 7702 of the IRC and are also known as the Section 7702 tests.

### **Basis and Individual Life Insurance--**

Assuming a product qualifies as “life insurance” under the law, the key element in reviewing the taxation of individual life insurance is the concept of basis.

Basis in taxation is, in effect, the total costs attributable to an investment or purchase. With life insurance tax basis is the sum of all premiums paid plus all dividends received in cash. “Premiums paid”, however, does not include any premiums paid for any additional benefits, such as waiver of premium, if these can be calculated separately.

Keep the concept of basis in mind. It appears frequently in tax issues.

## **Individual Life Insurance:**

### **Premiums--**

Premiums paid for individual life insurance products, including premiums for additional benefits, are not deductible items for the federal income tax, whether the taxpayer itemizes or not. There are two common exceptions, however. Premiums paid for life policies gifted to or absolutely assigned to a qualifying charitable organization are deductible for taxpayers who itemize. And premiums paid as part of a court-approved alimony settlement are also deductible (and taxable as income to the receiving ex-spouse.)

### **Death Benefits--**

Since premiums aren't deductible, death benefits aren't taxable as income, either. And this principal also applies to the newer concept of accelerated benefits. Insureds may receive up to 2 per cent of the face amount of their policy a month as tax-free income if they are terminally ill, or 1 per cent a month if they are in a long-term care situation, up to a total of 50 per cent of the death benefit.

But there is an important exception to the principal that death benefits are not taxable.. If the policy violates the "transfer for value" rule, proceeds will be taxable as income. A transfer for value occurs whenever a policy is sold or transferred from one owner to another (not one insured to another) for any valuable consideration. Fortunately, there are five acceptable exceptions to the transfer for value rule. Any policy sold or transferred within one of these exceptions will not lose its tax-free death benefit.

The five exceptions are:

- transfers in which the transferee-owner is the insured.
- transfers to a partner of the insured (but not a fellow shareholder).
- transfers to a partnership in which the insured is a partner..
- transfers to a corporation when the insured is a shareholder or officer.
- transfers in which the transferee's tax basis is determined by the basis of the transferor.

Given these exceptions, it is difficult to violate the transfer for value rule. But one situation where violations can occur is when shareholders in a corporation assign or transfer individuals policies to their fellow shareholders as a means to guaranty a cross-purchase buy-sell agreement.

### **Settlement Options--**

While life insurance proceeds are generally not taxable to the recipient, the interest portion of settlement options is. These payments are taxed as if they were annuities, with the

portion attributable to the insurance principal received tax-free and the remainder taxable as income.

### **Additional Benefits–**

The premiums for additional benefits are also not deductible and do not count toward basis, while the benefits themselves are not taxable. Most importantly, premiums waived while disabled under a waiver of premium benefit do not trigger taxable income and any dividends received during that period are taxed as if the premium were being paid.

### **Dividends–**

The tax code considers policy dividends to be refunds of overcharges and thus not taxable, but there are two exceptions to this general rule. First, when the total of all dividends paid in cash exceeds the total premiums paid, the excess becomes taxable income (this rarely happens). Second, when dividends are accumulated at interest, the interest becomes taxable as if the account were passbook savings.

But dividends used to reduce premiums do not trigger either of these tax issues and dividends used to purchase one-year term or buy paid-up additions remain tax-free benefits.

### **Policy Loans and Withdrawals–**

Policy loans and withdrawals are not taxable income, unless the policy is surrendered with an forgiven (unpaid) loan. Then the loan is reported as taxable income by the insurer. This phenomenon is known as “phantom income.”

Interest on policy loans, even if paid, is considered consumer interest and is no longer deductible, even for taxpayers who itemize.

Consequently, the “inside buildup” of cash value is also not taxable, even if taken as loans, until the policy is surrendered. However, Congress periodically reconsiders its opinion on this particular tax advantage for the product and it is possible it could change someday.

### **Policy Surrenders–**

Surrendering a policy for cash does trigger a taxable event. If the cash value received, including unpaid loans, exceeds the basis, then the excess is taxable income in the year received. Most surrenders, however, result in a loss, although there is no provision in the Tax Code for deducting any losses.

The potential surrender penalty does not apply to the election of the other two non-forfeiture values—extended term insurance or reduced paid-up insurance. The remaining death benefits remain tax-free and the cash value (in reduced paid-up) may be borrowed on a tax-free basis. The surrender of a reduced paid-up policy is treated just like the surrender of an active policy.

## **Section 1035 Exchanges–**

Another important tax advantage for life insurance is the tax-free exchange provision contained in Section 1035 of the Tax Code.

A 1035 exchange permits a policyowner to exchange one life policy for another without penalty, provided that the entire cash value is transferred from the old policy to the new one. In effect, the policyowner is permitted to rollover his basis to the new policy.

Also, a life policy may be exchanged for an endowment contract or an annuity under the same Section 1035 rules. (An endowment may be exchanged for another endowment or an annuity, but not a life policy. And an annuity may only be exchanged for another annuity.)

## **Modified Endowment Contracts–**

Some of these tax advantages are lost if the life policy is determined to be a Modified Endowment Contract (MEC), although the term is misleading because a MEC has nothing to do with a contractual endowment.

A MEC is a life insurance policy that has failed the 7-pay test, meaning that too much premium was paid in during the policy's first seven years. Congress wrote these rules to protect against another of a series of tax-avoidance abuses. By definition all single-premium life products are MECs.

A MEC can never lose its status. Once a MEC, always a MEC. MEC status is not necessarily a bad thing. The tax-free death benefit is unaffected, as is the tax treatment upon surrender. What are affected are policy loans and withdrawals. In a MEC these lose their FIFO accounting status (first-in, first-out) and are treated on a LIFO basis (last-in, first-out), meaning that loans and withdrawals trigger taxable income until the total taken equals the basis. In effect, MECs are taxed as if they were annuities in these transactions.

## **Corporate-Owned Life Insurance:**

Corporate-owned life insurance (COLI) is, for the most part, taxed as if it were individually-owned. That is, premiums are not deductible and proceeds are not taxable. This is especially true for policies used to fund key person benefits and buy-sell agreements. Remember, however, that using individual policies to fund a cross-purchase agreement may trigger the transfer-for-value tax trap.

Likewise, the tax rules regarding settlement options, policy loans, dividends, surrenders and MEC status are the same for COLI as for individual policies, with one important exception. Loans and death benefits for certain large policies are preference items and may trigger the corporate alternative minimum tax. The rules governing this are complex, and frequently changed, but it is an issue that practitioners must be alert to.

## **Split Dollar–**

Split dollar plans are almost impossibly complex, but the general rule is that as long as the corporation owns the policy, then the employee is subject to taxation only on the imputed value of the premium, called the Table 2001 cost (formerly the P.S. 59 cost). In effect the employee pays income tax on the equivalent to the premium for a 1-year renewable term policy. With tax rates so low, this tax treatment makes split dollar very attractive. It creates insurance at a discount.

Reverse and equity split dollar, where the employee owns the policy, is a much more problematic issue. For a more detailed discussion of split dollar see “Understanding Employee Benefits”, a companion text from Insurance Schools.

## **Deferred Compensation–**

Although life insurance is commonly used to assure a participant in a deferred compensation plan that benefits truly will be paid, great care must be taken so that the plan remains “unfunded.” (Funding deferred compensation with COLI creates an unfunded plan.)

As long as the plan is unfunded, the participant does not generate imputed income upon the payment of the premium. In other words, the plan does not trigger any tax effects until the benefits are actually paid. At that time those benefits will represent taxable income. (In the typical deferred compensation arrangement the corporation owns the policy and names itself beneficiary. Upon the death of the plan participant the corporation receives the proceeds and pays an equivalent amount—usually in annual installments—to the participant’s beneficiary. It is those corporate payments that are subject to income tax.)

## **Estate and Gift Taxes:**

The unified federal estate and gift tax law has been much modified in recent years and may disappear forever if one party gets its way.

But for now the impact of the estate tax upon life insurance is quite clear. A policy is included in the estate of whoever possessed “incidents of ownership” at the time of the death of the insured.

Policyownership itself is, obviously, an incident of ownership, but so are many forms of limited ownership, including the right to name a beneficiary. This latter ruling affects split dollar plans.

Generally, if you enjoy any right of ownership, you are likely to have the policy’s death benefit included in your estate for purposes of calculating your gross estate. And the size of your gross estate determines whether an estate tax may be due.

Policies intended as gifts, and thus qualifying for the annual gift tax exclusion (currently \$12,000 per recipient), must be “gifts of the present interest”, meaning that nothing may prevent or delay a policy beneficiary from full enjoyment of the proceeds upon the death of the insured. (The gift, of course, is the premium payment, not the proceeds.)

Paying proceeds into a trust does not violate this principal, since the trust, in the guise of the trustee, is the policy beneficiary and may act immediately. (The beneficiaries of the trust are indirect to the policy.) But imposing spendthrift clauses on a direct beneficiary could cause a life policy to be ruled as something other than a gift of the present interest. Remember, though, that this determination only applies to policies seeking to qualify under the annual gift tax exclusion.

### **Group Life Insurance–**

The taxation of group life insurance is rather simple, on the premise that the vast majority of group life plans are group term insurance and almost all are sponsored by an employer for its employees.

Also, to earn its tax status a group life plan must meet all the tests for a qualifying health and welfare benefits plan, meaning that it must not discriminate improperly and must be established for the benefit of the participants (usually employees). For a more detailed examination of these requirements see the companion text, “Understanding Employee Benefits.”

### **Group Premiums–**

Premiums for qualifying group life plans, whether term or not, are deductible to the employer and not taxable to the employee, with one important exception.

The premium for group life benefits for amounts in excess of \$50,000 paid by an employer creates imputed income for the employee and require the employee to pay tax on that amount. Since this is annoying to the employees, and a real burden on employers, very few group plans have employer-paid premiums for amounts greater than \$50,000. (There is no penalty if the employee pays that portion of the premium.)

Furthermore, this tax-free threshold is reduced to just \$2,000, if the employer-paid group life benefit also covers dependents. Thus, few plans do. Again, the employee can pay for that coverage without penalty.

### **Cafeteria Plans–**

Finally, voluntary group life plans (those elected by and paid for by the employee) may be included in popular cafeteria plans under Section 125 of the Tax Code, but they may not be provided on a pre-tax basis. In other words, group life is eligible for payroll deduction but all employee-paid premiums are always made with after-tax dollars.