WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

Topic: Life Insurance & Income Tax: Knowledge Increases Your Value

MARKET TREND: The growing sophistication of life insurance products and continued complexity of the tax laws increases the importance of the insurance advisor's role in all phases of the life insurance plan, from policy selection and acquisition to maintenance and management. Clients will place a premium on advisors who remain informed on the current taxation of life insurance and maintain contact post-sale.

SYNOPSIS: Specific federal income tax rules apply to tax the cash value and death benefits of life insurance policies, provided the contracts meet the definition of "life insurance" under the Internal Revenue Code ("Code"). For many policies, income tax is deferred on cash value growth if it remains in the policy, and the death benefits paid upon the insured's death are excluded from gross income. Numerous exceptions apply to the rules, which can lead to unexpected income tax consequences for uninformed clients, particularly when dealing with: (1) modified endowment contracts ("MECs"), (2) policy withdrawals and loans, (3) split-dollar arrangements, (4) transfers for value, and (5) employer-owned life insurance ("EOLI").

TAKE AWAY: While the income tax laws related to life insurance contracts defer income tax on policy cash value and exclude death benefits from gross income, application of these rules requires strict compliance. Small oversights in policy selection, acquisition or subsequent management can trigger unanticipated income tax exposure. Advisors can add value by investing in knowledge of the tax issues, working with a qualified team of advisors, and maintaining client contact post-sale to help their clients comply with the rules and preserve the intended tax treatment of their life insurance policies.

PRIOR REPORTS: 12-24; 12-47; 13-18; 14-15.

Recent tax changes and the development of more complex life insurance products have increased the potential for unexpected income taxation for uninformed clients. Knowledge of the basic income tax rules applicable to life insurance and an awareness of common trouble spots can help advisors guide their clients with regard to tax compliance and minimize the risk of tax exposure.

Life Insurance for Tax Purposes

To qualify as "life insurance" for federal income tax purposes,[1] a life insurance policy must meet the following statutory requirements of Code §7702:

1. State Law. The policy must be considered a life insurance contract under applicable state law (*i.e.*, involve both risk-shifting and risk-sharing).

2. Cash Value Tests. The policy must satisfy one of two computational tests related to the policy's cash value ("**CV tests**"), referred to as (a) the cash value accumulation test and (b) the combination guideline premium-cash value corridor test. The CV tests target policies with a cash value component and are designed to prevent the excessive build-up of policy cash value relative to the life insurance risk insured (*e.g.*, by preventing the payment of excess premiums over those necessary for the insurer to provide the promised death benefit).[2]

Assuming most retail policies meet state law requirements for life insurance, ongoing satisfaction of a CV test is key to preserving the income taxation of a policy as "life insurance."

✓ ***Practice Note:*** As the CV tests are highly technical and require significant computations, most advisors and clients will be unable to independently confirm that a policy qualifies as life insurance under the Code. Accordingly, insurance advisors can provide value to their client by obtaining written representations from the carrier stating that: (1) the policy currently qualifies, and is designed to continue to qualify, as "life insurance" under Code §7702, and (2) the carrier will take appropriate actions to ensure future compliance. Note that confirmation should be requested for all riders to the policy (*e.g.*, long-term care riders), as qualification of the basic policy as "life insurance" does not automatically extend to riders.[3]

MECs vs. Non-MECs

Another factor affecting the Code's taxation of a life insurance policy is its classification as a MEC. MECs are life insurance contracts where the total premiums paid in the first seven years of the policy exceeds the amount needed to provide for a paid-up policy based on statutorily set level annual premiums (*i.e.*, most of the premiums are paid in the initial years of the contract).[4] MECs are life insurance for tax purposes, but subject to very different rules regarding the income taxation of withdrawals of cash value, as described below.

Basic Income Taxation of Life Insurance

For policies qualifying as life insurance, Code §101 and §72 provide specific rules for the income taxation of the growth and access to cash value and the payment of death benefits under such policies, depending on whether the contract is a MEC or non-MEC:

Income Taxation	Non MEC	MEC
Tax on Cash Value Growth within Policy	**No.**	
Tax on Withdrawals / Surrenders / Loans	**No.** • Withdrawals: no tax until exceed owner's investment in the contract ("**basis**")[5] • Complete surrenders: taxed as ordinary income for amounts in excess of owners' basis in contract • Policy loans: no tax	**Yes.** • Withdrawals: taxed as ordinary income until exceed gain in MEC • Policy loans and pledges as loan collateral: taxed as withdrawals • Complete surrenders: taxed as ordinary income for amounts in excess of owners' basis in contract
Penalties on Withdrawals / Loans	**No.**	**Yes**. 10% penalty on includible MEC distribution with few exceptions (*e.g.*, owner is 59 ½+ or disabled)[6]
Income Tax on Death Benefit	**No**, if, under Code §101, no prior "transfer for value" and, if EOLI, compliance with notice & consent provisions (see below)	
Estate Tax on Death Benefit	**Yes**, generally, unless policy is held in a properly structured irrevocable trust	

✓ ***Practice Note:*** For purposes of the 3.8% net investment income ("**NII**") tax, if an amount is not included in gross income, including any cash value withdrawal or death benefit under a life insurance policy, then it also ***is not includible in NII***.

PRESERVING THE TAX TREATMENT OF LIFE INSURANCE

There are numerous exceptions to application of the above rules, which, could lead to significantly different, and unexpected, income tax results for unaware clients and advisors. Some common trouble spots include the following:

Tax Triggers on Cash Value

Avoid MECs When Cash Value Needed. When acquiring coverage for an individual, the advisor should determine whether the client will have a future need or desire to access the policy's cash value, such as at retirement or to fund distributions to a spouse under a spousal lifetime access trust. Clients should avoid MECs in these cases, as both policy loans and withdrawals of the cash value would be subject to income tax until all gain in the policy has been distributed (essentially the excess of cash value over premiums paid). In addition, a 10% penalty tax may apply on the includible amount of the distribution. Finally, if the policy acquired is a MEC, it remains a MEC. The status cannot be changed, even upon an exchange of the policy.

✓ ***Practice Note:*** Given the tax ramifications of MEC status, the selection between a MEC and a non-MEC product should weigh the importance of access to policy cash vale as compared to any investment benefit provided by front-loading the premiums. The investment analysis should consider several factors, including that (1) low interest rates have diminished some of the merits of front-loading premiums and (2) a non-MEC generally offers a higher internal rate of return in the case of the client's premature death.

Choose Policy Carefully with Split-Dollar Loans. Pledges of a MEC as collateral for a loan are taxed like cash value withdrawals and policy loans -- as ordinary income until they exceed any gain in the contract.[7] They also are subject to the additional 10% penalty tax on the amount included in gross income.

✓ ***Practice Note:*** Where a life insurance policy will be pledged as collateral for a split-dollar loan, MEC status likely is undesirable.

Evaluate Withdrawals in First 15 Years. A withdrawal of policy cash value in the first 15 years of a non-MEC contract that ***reduces the future death benefits may generate an immediate income tax liability***. The withdrawal is includable in gross income to the extent of the policyholder's gain in the contract (excess of the policy's cash value over the policyholder's basis). The amount taxable as ordinary income depends on when during the initial 15 years the benefit reduction occurred (with the likelihood of taxation higher for withdrawals in years 1-5) and which CV test is applied to determine the "recapture ceiling" for the policy.[8]

✓ ***Practice Note:*** Advisors can add value for clients who are considering cash value withdrawals during the first 15 years of a policy, and particularly during the first five years of the policy, by confirming with the carrier whether the contemplated withdrawal will result in a benefit reduction and thus possible taxation on some/all of the withdrawn amount. If a grantor trust owns the policy (as is common) and makes the withdrawal, the grantor would be liable for the tax but often would not have access to the trust funds to pay the liability.

Review Policy Loans Before Policy Exchanges/Surrenders. The discharge of a policy loan upon an owner's surrender of a policy or transfer of the encumbered policy to another person (other than to the owner's wholly-owned grantor trust)[9] will result in taxable income if the loan exceeds the owner's basis in the policy. This potential exposure exists whether or not the policy surrender is voluntary. For example, if a carrier cancels a policy subject to an outstanding policy loan for the non-payment of premiums, the policy owner will have taxable income to the extent the outstanding loans exceed the owner's basis.[10] In addition, a tax-free "1035 exchange"[11] of a policy with an outstanding policy loan will result in taxable "boot" to the owner in an amount equal to the loan discharged unless the policy received in exchange is similarly encumbered.

✓ ***Practice Note:*** Before taking any actions with regard to the surrender, transfer, or exchange of a policy by a client or a client's insurance trust, the advisor should obtain and review with the client the policy's cash value, the balance of any outstanding policy loans, and the potential for any taxable gain if the owner's basis will be less than the policy's cash value (*e.g.*, potentially resulting from the discharge of a policy loan).

Proceed Cautiously When Terminating/Modifying Grandfathered Split Dollar Arrangements. The taxation of so-called "grandfathered" split dollar arrangements ("**SDAs**") -- those entered into on or before the effective date of the final split-dollar regulations (Sept. 17, 2003) -- differs dramatically from those governed by the final regulations. For example, if a business and an insured enter into a SDA governed by the economic benefit regime under the final regulations, the insured is currently taxable on his or her current or future access to policy cash value in excess of the reimbursement due to the business (*i.e.*, the policy equity). Under a grandfathered SDA, however, this policy equity may not be taxable while the arrangement remains in place, ***but may become immediately taxable if accessed or if the SDA is terminated or materially modified.*** The final regulations, however, do not define "material modification" and do not address whether a 1035 exchange is a material modification for these purposes.

✓ ***Practice Note:*** Many grandfathered SDAs remain in place, and parties to the SDA may approach advisors for assistance in making adjustments to terms or coverage without realizing the potential tax consequences of their desired changes. If a policy underlying a grandfathered SDA has any equity, then parties to the arrangement should understand that any changes to the SDA or the policy (including termination of the SDA and transfer of the policy to, or retention of the policy by, a retiring/departing employee) may result in immediate and potentially significant income tax to the insured on that equity.

Tax Triggers on Death Benefits

Prevent Inadvertent Transfers for Value. Despite the general exclusion of policy death benefits from taxable income, if there is a transfer for value ("**TFV**") of a policy, the recipient of the death benefit can only exclude from gross income the total consideration, subsequent premiums, and other amounts paid by the transferee for the policy (the "**TFV rule**"). The excess death benefit is then taxed at ordinary income tax rates.

Several exceptions apply to the TFV rule, including for transfers of a policy (1) to the insured (including to an insured's wholly-owned grantor trust); (2) to the partner of the insured, (3) to a partnership (including a LLC taxed as partnership) in which the insured is a partner, (4) to a corporation in which the insured is an officer or shareholder; and (5) where the transferee's tax basis is determined, in whole or in part, by the transferor's basis (*e.g.*, a gift).[12]

Despite these exceptions, inadvertent TFVs can occur if advisors and clients do not carefully review the transaction. The transfer of a policy subject to a loan could result in the application of the TFV rule, even if the transfer is intended as a gift. For example, if a client makes a gift of a life insurance policy to his child, subject to an outstanding policy loan that exceeds the client's basis in the policy, the transfer will be deemed a sale, not a gift. The child will takes a basis in the policy equal to the sale price (*i.e.*, the loan amount). The TFV rule applies, without exception, and will result in income taxation of the death benefit at ordinary income tax rates.

✓ ***Practice Note***: Whenever a transfer of a policy is recommended to or contemplated by a client, the insurance advisor should work closely with the client's legal counsel to ensure the client does not run afoul of the TFV rule. This issue is particularly important in policy sales to irrevocable life insurance trusts ("**ILITs**") which seek to take advantage of the TFV exception for transfers of a policy to the insured. The ILIT must be properly drafted to provide certain powers to the grantor or the ILIT trustee that will not only trigger wholly-owned grantor trust status with regard to the insured for income tax purposes, but also prevent inclusion of the trust assets in the grantor's estate for estate tax purposes.[13]

<u>Ensure Economic Benefit Split Dollar Reporting</u>. Under an economic benefit SDA governed by the final regulations, the deemed "non-owner" of the policy (*i.e.*, the insured or his or her ILIT) generally is the person who benefits from current life insurance coverage. ***Death benefits paid to the insured's designated beneficiary generally are excluded from gross income under Code §101, but only to the extent the insured paid or reported the annual cost of current life insurance protection as an economic benefit.***[14] Otherwise, the final regulations treat the deemed policy owner (*e.g.*, the insured's employer) as receiving the full death benefit and then paying the applicable amount to the non-owner's beneficiary, subject to tax based on the relationship of the parties to the SDA (*e.g.*, as compensation in an employer/employee relationship).

✓ ***Practice Note***: It is critical that the insured/non-owner annually report or contribute the cost of the annual economic benefit provided under an economic benefit SDA, or the death benefits payable to the non-owner's beneficiary may ***lose their exclusion from income tax***.

<u>Review EOLI</u>. Code §101(j) requires the owner of certain EOLI contracts ***to include in gross income otherwise excludible policy death benefits*** to the extent they exceed the total premiums and other amounts paid by the owner (*i.e.*, the business) for the contract. ***Any policy where the business owns the policy, and the business (or a related person) will receive the death benefits can constitute EOLI***. Broad exceptions apply to this rule (including for benefits paid to the insured's heirs or designated beneficiaries),[15] which will exclude most EOLI proceeds from taxation. ***The business, however, must satisfy certain notice and consent requirements with regard to the insured employee <u>before</u> issuance of the EOLI contract.*** Otherwise, a portion of the death benefit proceeds may be subject to income tax.

✓ ***Practice Note:*** Compliance with the notice and consent requirements is the policyholder's responsibility, and the IRS has provided for specific corrective measures only in very limited circumstances.[16] Otherwise, correcting the failure likely will involve (1) cancelling the policy and issuing a new one or (2) affecting a material change in the policy (and obtaining notice and consent prior to issuance of the new policy or changes to the existing policy). Thus, ***in any business planning situation, if there is any doubt about whether a policy may be an EOLI contract, the advisor will want the business and insured to satisfy the EOLI notice and consent requirements <u>before</u> policy issuance to preserve all available exceptions.***

TAKE-AWAYS

- While the income tax laws related to life insurance contracts defer income tax on growth in policy cash value and exclude death benefits from gross income, application of these rules requires strict compliance.
- Small oversights in policy selection, acquisition or subsequent management can trigger unanticipated and significant income tax exposure.
- Advisors can add value by investing in knowledge of the tax issues, working with a qualified team of advisors, and maintaining client contact post-sale to help their clients comply with the rules and preserve the intended tax treatment of their life insurance policies.

NOTES

[1] The definition applies to contracts issued after 1984 for all federal tax purposes.

[2] With the cash value accumulation test, the policy's cash value can never exceed the amount of a single premium that would be required to fund a future death benefit claim under the policy, based on reasonable actuarial assumptions. Under the alternative guideline premium-corridor test, the net premiums paid cannot exceed the greater of (1) the single premium that would have been required at issuance to fund future benefits under the contract or (2) the sum of the level annual premiums that would be required for the same purpose for the life of an insured who lives until 95. Also, the policy's cash value cannot exceed set percentages of the death benefit based on various age brackets for the insured. *See* Code §§ 7702(a) – (d). *See also* Westfall & Mair, *Estate Planning Law and Taxation*, §5.03 (Thomson Reuters/Tax & Accounting, 4th ed. 2001, with updates through February 2014) (online version accessed on Checkpoint (www.checkpoint.riag.com) August 2014).

[3] *See e.g.*, PLR 9106050. *See also* discussion in treatise by Zaritsky & Leimberg, *Tax Planning With Life Insurance: Analysis With Forms*, §4.02 (Thomson Reuters/WG&L, 2d Ed. 1998, with updates through May 2014)(online version accessed on Checkpoint (www.checkpoint.riag.com) August 2014).

[4] *I.e.*, the "**seven-pay test.**" For contracts entered into or materially modified after June 21, 1988 (Code §7702A).

[5] As defined in Code §72(e)(6), which provides that investment in the contract is the (A) aggregate amount of premiums or other consideration paid for the contract, minus (B) the aggregate amount received under the contract, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

[6] Code §72(v).

[7] Code §72(e)(10).

[8] Code §7702(f).

[9] Since the transfers should be disregarded for federal income tax purposes.

[10] *See*, *e.g.*, *Brown v. Commissioner*, 693 F.3d 765, (7th Cir. Sept. 11, 2012), aff'g T.C. Memo. 2011-83; *Black v. Commissioner*, T.C. Memo 2014-27 (2014).

[11] Tax -free exchanges of life insurance policies as provided under Code §1035.

[12] Code §101(a)(2).

[13] *See* discussion in *Washington Report* No. 12-47 (trust to trust policy sale) and *Washington Report* No. 13-18 (drafting ILITs as grantor or non-grantor trusts).

[14] Reg. § 1.61-22(f)(3).

[15] Code §101(j)(2). The exceptions are if: (1) the insured under the contract was (a) an employee at any time during the 12 months prior to death, or (b) a director or a highly compensated employee or individual at the time the contract was issued, or (2) the contract death benefits are either (1) paid to the insured's estate, family members, or other designated beneficiaries (other than the policy-holder), or a trust for the benefit of any such individuals, or (2) used to purchase an equity (or capital or profits) interest in the policyholder from any person described above.

[16] *See* Notice 2009-48.

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