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The WRNewswire is created exclusively for AALU Members by insurance experts led **by Steve Leimberg, Lawrence Brody and Linas Sudzius. WRNewswire #16.06.27** was written **by Linas Sudzius of** Advanced Underwriting Consultants**.**

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TOPIC: Lapse of Policy Subject to a Loan Leads Generates Taxable Income for Policy Owner

CITATION: Mallory v. Commissioner; T.C. Memo. 2016-110; No. 14873-14 (June 6, 2016).

SUMMARY: Kenneth Mallory purchased a modified single premium variable life insurance policy with Monarch Life Insurance Company, prior to the enactment of Code Section 7702A, so that it was not a modified endowment contract. He made a single premium payment of $87,500.

Over the years, Mallory took a series of loans against the life insurance policy's cash value. In 2011, Monarch terminated the policy because its loan balance of 237,897 was greater than the policy's cash value. Monarch issued Form 1099-R to Mallory for 2011 showing a taxable distribution to him at the time of the policy's lapse of $150,397.

Mallory and his wife failed to include the income from the lapsed policy on their 2011 federal income tax return. The IRS imposed an assessment related to the unreported income, as well as penalties related to their failure to properly report. The Mallorys filed a petition in the Tax Court, disputing the assessed amounts. The court affirmed the imposition of the income tax liability and penalties.

RELEVANCE: The result in this case should not be a surprise to life insurance professionals. In WRNewswires 13.12.18 and 14.2.15, we reported on similar court decisions where a taxpayer's income tax liability upon lapse of a life policy subject to a loan was confirmed.

Agents routinely tout the benefits of permanent life insurance policies to their clients. For a non-MEC life contract, withdrawals or partial surrenders up to cost basis are income tax free and loans are not treated as taxable distributions at all, according to longstanding and appropriate tax principles, unless the contract is surrendered or it lapses, subject to the loan. Unfortunately, upon lapse, an existing loan balance is treated as a potentially income taxable distribution from the contract.

Clients do not always understand the practical consequences of taking loans against their life insurance contracts. Policy debt and associated loan interest can add strain to a contract's performance, putting the client's expectations at risk and creating a potential tax time bomb if the policy is surrendered or is allowed to lapse when the loan is outstanding.

Life insurance professionals have the opportunity to educate their clients both during the sales process and during policy reviews to help clients understand how their policies work. Such understanding can help them avoid unpleasant surprises.

FACTS: In 1987, prior to the enactment of modified endowment taxation rules, Kenneth Mallory purchased a single premium variable life insurance policy with Monarch Life Insurance Company. He made a single deposit of $87,500. The policy named Kenneth Mallory as the insured and as the policy's owner and it named his wife Larita as the beneficiary.

The policy provided that Kenneth could borrow from Monarch Life and that the loans were secured by the policy. Any unpaid interest would be added to the outstanding loan amount. The policy provided that, if the policy debt ever exceeded the cash value of the policy, Monarch would terminate the policy after giving Kenneth Mallory notice of the pending termination and an opportunity to pay down the policy debt to avoid termination.

From 1991 through 2001, Kenneth Mallory took out numerous loans against the policy in the aggregate total of $133,800.

The cash value of the policy increased substantially. However, the policy debt also grew as Kenneth Mallory took out loans from Monarch against the policy without repaying the loans or paying the interest on those loans.

On October 17, 2011, Monarch sent Mallory a letter informing him that the policy debt had exceeded the cash value. The letter also informed him that to avoid termination of the policy he had to make a minimum payment of $26,061.67 by December 17, 2011. The letter further explained that termination of the policy would result in a taxable event and that Monarch Life would report any taxable gain to Kenneth and the IRS on a Form 1099-R. Kenneth received this letter, but did not make the required payment, and Monarch terminated the policy on December 17, 2011.

Monarch issued Kenneth a Form 1099-R for 2011 showing a gross distribution of $237,897.25, insurance premiums of $87,500, and a taxable amount of $150,397.25. He received the Form 1099-R before the April 15, 2012 filing deadline for the 2011 individual income tax return.

Kenneth and Larita Mallory showed the 1099-R to their tax preparer, who told them they would owe a substantial amount of tax due to the lapse of the policy. Not liking that news, Larita apparently telephoned other tax preparers and the IRS itself, asking if the Form 1099-R was correct. No one was willing to give her an opinion about the accuracy of the Form 1099-R.

The Mallorys did not report income from the Form 1099-R on their 2011 Form 1040, and they waited until March of 2013 to file the tax return. They did, however, attach to their income tax return the Form 1099-R and a handwritten note that said:

> Paid hundreds of $. No one knows how to compute this using the 1099R from Monarch--IRS could not help when called--Pls send me a corrected 1040 explanation + how much is owed. Thank you

The IRS issued a notice of deficiency to the Mallorys for the 2011 taxable year. In this notice, the IRS determined an income tax deficiency of $40,486, in addition to tax for failure to timely file under section 6651(a)(1) of $10,122, and an accuracy-related penalty under section 6662(a) of $8,097.

The Mallorys filed a petition in the Tax Court disputing the assessments. In their argument over the tax deficiency, they claimed that Kenneth's distributions from the policy were not loans at all.

> The Mallorys deny that they had any policy debt. They contend that the amounts Kenneth Mallory received from 1991 to 2001 were distributions of the cash value of the policy that he did not have to pay back. Because there was no policy debt to extinguish (in their view) and because Kenneth Mallory did not physically receive any payments from Monarch Life in 2011, the Mallorys contend they had no income from Monarch for 2011.

The court quickly rejected their argument, finding it without merit. The court also affirmed the extra assessments for late filing and inaccurate reporting of income.
