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Lee J. Slavutin is a principal in Stern Slavutin 2, Inc., an insurance and estate planning firm in New York. He graduated from Monash University Medical School in Melbourne, Australia in 1974 and became a Fellow of the Royal College of Pathologists of Australia and a Diplomat of the American Board of Pathology in 1981. Dr. Slavutin left the practice of medicine in 1982 and entered the life insurance business in 1983. He is a member of the Association of Advanced Life Underwriting and the Million Dollar Round Table and is a Chartered Life Underwriter with the American College. Dr. Slavutin has published over 160 articles on insurance and estate planning topics for CCH, Warren Gorham and Lamont, Practitioners Publishing Company (PPC), New York Law Journal and others. He is a member of the CCH Estate and Financial Planning Advisory Board, and the Tax Advisory Panels of PPC and Tax Hotline. He is the Author of *PPC's Guide to Life Insurance Strategies*, 14th edition (2013), published by Thomson Reuters. Dr. Slavutin has spoken before the American Law Institute/American Bar Association, the New York County Lawyers' Association, the American Institute of Certified Public Accountants (CPAs), the New Jersey State Society of CPAs, the Association of Advanced Life Underwriting, the Million Dollar Round Table, and the UJA-Federation Annual Tax and Estate Planning Conference, as well as many New York accounting and law firms. He was invited to testify before the New York State Senate on the effectiveness of the insurance rating firms and worked with the U.S. General Accounting Office on a similar project. He is married to Dee and they have two children, Aaron and Lydia.

# **Life Insurance Tax Issues to be Aware Of**

Life Insurance policies are subject to unique tax rules (involving income, gift, estate and generation skipping transfer taxes), and as many as for different parties are involved in the creation of one contract (insured, beneficiary, owner and premium payor). Unexpected tax traps can arise when a policy is issued or transferred from one person to another. The purpose of this article is to highlight some common tax traps so that practitioners will be sensitized to them and either avoid them or cure them when discovered.

## **Tax Issues Related To Ownership of the Policy**

Ownership of policies by a C Corporation can result in the imposition of the alternative minimum tax (AMT). The corporation may own the policy for key person insurance or a redemption – type shareholder buy-sell agreement. The excess of the death benefit over the corporation's basis for purposes of ACE (adjusted current earnings) is included in the ACE. For taxable years beginning after 1989, 75 percent of the amount by which a C corporation's ACE exceeds its AMTI is added to the AMTI.

*Example: ABC Corporation owns a \$1 million key man policy on Jack Smith with a basis (for purposes of the adjusted current earnings) of \$200,000 as of December 31, 1997. ABC Corporation paid a premium of \$16,000 on January 1<sup>st</sup>, 1998. Assume that Mr. Smith dies in 1998, after the premium was paid.*

The corporation must include in ACE the excess of the death benefit over basis, that is, \$784,000 (\$1 million minus \$200,000 minus \$16,000). The \$784,000 is potentially subject to a maximum tax of 15 percent (AMTI rate of 20 percent times 75 percent).

Policy ownership is also important when a husband and wife get divorced. It is not uncommon for a divorce agreement to require one spouse to acquire a life insurance policy and name the ex-spouse as a beneficiary. The premium payments may be tax deductible as alimony if the policy is structured correctly.

*Example: Sam owns a \$200,000 term insurance policy on his life pursuant to a divorce agreement. His ex-wife, Susan, is named as the beneficiary. The annual premium of \$1,000 is not tax deductible.*

If, however, Sam increases his alimony payments by \$1,000 and Susan owns the policy then the premium is income tax deductible.<sup>2</sup>

A third trap related to the ownership of a policy occurs in relationship to deductibility of interest expenses. The 1997 Taxpayer Relief Act added Sec. 264(f) to the Code. Under this Sec., a business which owns cash value life insurance policies on its shareholders,

partners, or employees may lose part of its ordinary business deduction for the interest expense incurred on loans unrelated to the insurance policies.

*Example: Medical Group Partnership has 10 equal partners, each owning a 10 percent interest in the partnership. In 1999, the partnership has assets of \$3 million and owns key person whole life insurance policies (the policies were issued in 1998) on the partners with an aggregate cash value of \$300,000. The partnership borrows \$1 million from Chase Bank to fund an equipment purchase. The partnership pays \$80,000 in interest expense in 1999. Under Sec. 264(f), the interest expense is disallowed to the extent it can be allocated to unborrowed cash values. The aggregate cash value of the policies represents 10 percent of the partnership's assets. Therefore, 10 percent of the interest expense, that is \$8,000, will be disallowed in 1999.*

This provision applies to life insurance policies issued after June 8, 1997. There are certain exceptions. For example, policies on the lives of 20 percent owners, officers, directors or employees are exempt from the provision. However, partners are not classified as employees for income tax purposes, and therefore do not qualify for this exception. Furthermore, in the above example, the partners are less than 20 percent owners and do not qualify for that exception either. This is a difficult rule and a rule that many people may be not aware of.

### **Tax Issues Related to the Beneficiary Designation**

When a C corporation owns a life insurance policy on a shareholder and names someone other than itself or its creditors as the beneficiary of the policy, the death proceeds may be deemed a dividend if paid to or on behalf of the shareholder. The IRS has taken the position that life insurance proceeds paid to shareholders of a corporation are taxable as dividends when the corporation uses the earnings to pay the insurance premiums and has all the incidents of ownership in the policy. The IRS is treating the transaction as if the corporation received tax-free insurance proceeds and then distributed the proceeds as a dividend to the shareholders.<sup>3</sup>

*Example: Sam is a 40 percent shareholder in XYZ Corporation and his son, Jim, owns the other 60 percent. Sam purchases a \$1 million life insurance policy and wants the corporation to pay the premiums because it is in a lower tax bracket than he is. He names XYZ as the owner of the policy and his son, Jim, is named as the primary beneficiary. When Sam dies, the \$1 million of proceeds is taxed as dividend to Jim.<sup>4</sup>*

To avoid this disastrous result, the corporation should not own the policy. If Sam wants his son to be the beneficiary, then his son should also be the owner of the policy, or an irrevocable trust should be the owner and beneficiary of the policy.

Another common trap related to the beneficiary designation occurs when the insured, policy owner, and beneficiary are three different parties.

*Example: Sally owns a \$1 million insurance policy on the life of her husband, Jack, and names their child as beneficiary. When Jack dies, Sally is deemed to make a gift of \$1 million to her child.<sup>5</sup>*

To avoid this problem, the child or an irrevocable trust should be the owner and beneficiary of the policy. We call this trap the unholy trio, because three different parties are involved as the insured, owner and beneficiary of a life insurance policy. In general, there should only be two parties involved: the insured, and the owner/beneficiary (owner and beneficiary are the same person).

### **Tax Issues Related to Policy Loans**

The first trap related to policy loans occurs when a qualified plan borrows against the cash value of a life insurance policy owned by the plan, and then reinvest the borrowed funds to generate additional income. The additional income is treated as debt-financed income or unrelated business taxable income (UBTI). Even though a qualified retirement plan is a tax exempt trust, it must report this income and pay taxes on it.<sup>6</sup>

*Example: A profit sharing trust borrows \$400,000 from the cash value life insurance policies it owns. The interest charged on the loan is 7 percent. The trustee reinvests the loan proceeds in marketable securities yielding 10 percent. The income generated by the securities is income generated from debt-financed property and is characterized as unrelated business taxable income. The trust receives income of \$40,000 (\$400,000 times 10 percent) and has an interest expense of \$28,000 (\$400,000 times 7 percent). Its net income is \$12,000. A \$1,000 deduction is allowed to a qualified trust (Internal Revenue Code Sec. 512(b) (12)). The income must be reported on form 990T (exempt organization business income tax return).*

The second policy loan trap occurs when a policy encumbered with a loan is transferred from one family member to another as a gift.

*Example: Nathan owns a \$1 million whole life insurance policy on his life. His basis in the policy is \$200,000 (the aggregate of premiums he has paid less any dividends he received in cash). The policy has a cash value of \$340,000 and a value for gift tax purposes (interpolated terminal reserve plus unearned premium) of \$320,000. He is advised by his financial planner to give the policy to his daughter, Lydia, in order to remove the death benefit from his estate, assuming that he survives three years after the gift. He has also advised to take out a policy loan of \$300,000 in order to minimize the value of the gift. Nathan takes out the loan and then transfers the policy to Lydia. The transfer is treated as part gift and part sale.*

The value of the gift is the policy's fair market value, that is its gift tax value minus the amount of the loan (\$320,000 less \$300,000, that is \$20,000).

The transfer of a policy subject to a loan result in the discharge of a liability, because the loan liability goes with the policy from Nathan to Lydia, in this example. Discharge of a liability is treated as consideration received. The amount of the liability discharged is the amount of the policy loan, which is \$300,000 in this example. The taxable gain to Nathan is the amount of consideration minus his basis, which is \$300,000 minus \$200,000, which is \$100,000.

However, the tax problem gets worse. Whenever a policy is transferred and consideration is received by the transferor the transfer for value rule may be triggered. In this example, Nathan has received consideration of \$300,000 for the transfer of the policy. The only way out of this trap would be if Lydia's basis was the same as Nathan's basis, which is a carryover of basis. However, Lydia's basis is the greater of Nathan's basis or the amount that she paid for the policy (that is the amount of the loan that she ) plus the amount of increase, if any, in basis for gift tax paid.<sup>9</sup> In this example, Lydia's basis is the greater of \$200,000 (Nathan's basis) or \$300,000 (the amount of the loan). Her basis is therefore \$300,000 which is not the same as Nathan's basis and therefore there is no carryover of basis. Transfer for value has now been triggered. The death benefit in excess of Lydia's benefit in excess of Lydia's basis will be included in her income when Nathan dies. This is obviously an undesirable result. The way to avoid this is to either not take out a loan up to basis when the policy is transferred. If one discovers this error after the fact, the policy should be transferred back to the insured to eliminate the transfer for value problem. The loan can then be reduced to the donor's basis and re-transferred to the donor's child. These transfers may use parts of the unified credits of the donor and done, but this is much better than paying income tax on the proceeds at death.

A third policy loan trap occurs when a policy encumbered with a loan is surrendered.

*Example: Henry owns a \$500,000 variable life policy. He had taken out a \$100,000 loan against the cash value of the policy several years ago when he needed additional cash. His basis in the policy (premiums paid) is \$70,000. Henry receives a notice from the life insurance company that the life insurance policy has no cash value left because the loan has been accruing interest and has "used" all of the cash value. Henry is informed by the insurance company that his policy will lapse unless he makes additional premium payments. However, he decides that he no longer needs the policy and he allows it to lapse in November of 1998. In 1999, he will receive a form 1099 to report income resulting from the cancellation of his loan. The reportable income will be equal to the amount of the loan that was cancelled (\$100,000) plus accrued interest, say, \$30,000, less his basis (\$70,000). He will have to report income of \$60,000. For many clients, this might come as a rude shock. Clients should be advised that such phantom income will be triggered whenever a policy is surrendered and its loan exceeds basis.*

The fourth policy loan trap occurs when a modified endowment contract is used to secure a loan. A modified endowment contract is a policy where premiums have been paid into the policy in an accelerated fashion, usually over a period less than seven years. The upfront funding of the policy fails the so-called seven pay test for life insurance policies.<sup>10</sup>

(A contract fails to meet the seven pay test if the accumulated amount under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid up future benefits after the payment of seven level annual premiums). A modified endowment contract (MEC) is subject to special tax rules. For example, withdrawals or loans or any kind of distribution from a MEC are subject to income taxation to the extent that the cash value of the policy exceeds the policy owner for some other purpose from some other institution, then the loan secured will trigger taxation as if the loan was taken out of the policy itself. Obviously, MECs should not be used to secure a loan.

### **Tax Issues Related To Policy Transfers and Exchanges**

The first trap related to transfers occurs when policies are transferred from a corporation to a shareholder in order to switch from a redemption to a cross purchase buy-sell agreement. In a redemption agreement the corporation owns policies on the lives of its shareholders in order to fund the redemption of stock from a deceased shareholder's estate.

This arrangement has some potential disadvantages. For example, a C Corporation may have to pay alternative minimum tax, as described above, when it receives insurance proceeds. In addition, the surviving shareholders will not get a step up in basis when the shares are purchased by a C Corporation from the estate of a deceased shareholder. Therefore, a cross purchase agreement is often used to avoid the alternative minimum tax and to achieve a step up in basis. Problems might occur when one tries to switch from one kind of arrangement to the other.

*Example: Scott and Bill are 50 percent shareholders in S&B Incorporated, a C Corporation. They have decided to switch from a redemption buy-out agreement to a cross purchase arrangement for the reason described above. S&B Inc. owns two \$1 million insurance policies on Scott and Bill. The policy on Scott will be transferred to Bill and vice versa. Under the new cross purchase agreement, Scott will use the insurance proceeds on Bill's life to purchase Bill's shares from his estate when he dies and vice versa.*

The transfers of the policies from the corporation to its shareholders are treated as transfers for valuable consideration. The consideration received by the corporation for the policies is not at all obvious. The IRS has taken the position that when a corporation transfers policies, subject to a buy-sell agreement, to its shareholders, it is relieved of its obligations to pay premiums and redeem shares from the estate of the deceased shareholder. The relief of these obligations is treated as consideration.<sup>12</sup> The transfers described in this example do not qualify as an exception to the transfer for value rule,

because there is no exception for transfers to shareholders, unlike the exception that does exist when there are transfers to partners.<sup>13</sup> Thus, when Scott or Bill receives the million dollars of insurance proceeds, he will have to include it in his income to the extent it exceeds his basis in the policy (the premiums that he pays subsequent to the transfer).

How can one avoid transfer for value in this situation? One possible solution is to create a partnership in which Scott and Bill are partners. For example, Scott and Bill might create a partnership to manage the real estate which is leased to their business. Scott and Bill as partners will then qualify for the exception to the transfer for value rule (as partners of the insured).

The second trap related to transfers and exchanges occurs when clients exchange occurs when clients exchange individual policies for a second-to-die policy. Policies can be exchanged for one another without recognition of any taxable gain (i.e. a tax free exchange) when certain conditions are met.<sup>14</sup> Life insurance policies can be exchanged for other life insurance policies or for annuities. However, an annuity cannot be exchanged for a life insurance policy under Sec. 1035. A second important criterion is that the policies exchanged must relate to the same insured.

*Example: Jeff and Susan own individual insurance policies on themselves. Jeff owns a \$1 million policy on his life and Susan owns a \$500,000 policy on her life. Jeff and Susan want to exchange their policies for a new second-to-die policy with a death benefit of \$1.5 million because the premiums on the second-to-die will be lower than the aggregate premiums on their individual life policies. These exchanges will not qualify under Sec. 1035. The IRS has taken the position that Jeff and Susan must be treated separately and independently for purposes of the rules under Sec. 1035. Thus, when Jeff exchanges his policy for a new second-to-die policy, the insureds under the second-to-die policy and his policy are not the same (the second-to-die policy includes his wife as a second insured and she is not covered by his individual life policy). The IRS in a technical advice memorandum <sup>15</sup> would not allow the husband and wife to combine their policies for purposes of the same insured rule. When policies are exchanged and the exchange does not qualify as a 1035 exchange, any built-in gain in the original policies must be recognized as taxable income.*

### **Tax Issues Related To Life Insurance Trusts**

The language in an irrevocable life insurance trust related to the funding of estate taxes is critical to make the trust work. In fact, the trust should make no reference to the payment of estate tax. Rather, the trust should allow the trustee to lend money to the estate or purchase assets from the estate, in order to move liquid assets into the estate for the payment of the estate taxes.

*Example: Jill creates a life insurance trust which purchases \$3 million of insurance on her life. It is intended that the trust will use the proceeds to help fund estate taxes because Jill owns largely illiquid assets. The trust stipulates that the trustee is required to use the insurance proceeds to pay any estate taxes owed by Jill's estate. This is a disastrous mistake. Whenever the trustee is required to use the insurance proceeds to relieve the estate of any obligation, the proceeds are treated as payable for the benefit of the estate, and are subject to federal estate tax as if they were included in the insured's estate.<sup>16</sup>*

Whenever one discovers such an error in drafting before the trust is executed, obviously it should be corrected to use the language described above. What happens if one discovers such an error in an irrevocable insurance trust several years after it is executed and the client is now uninsurable and a new insurance policy cannot be purchased? One possible solution is to sell the existing policy to a new trust which is properly drafted. If both the new and the old trusts are grantor trusts for income tax purposes (with respect to the same insured), the new trust should have a basis in the insurance policy equal to the basis that the old trust has.<sup>17</sup> The carryover of basis from the old trust to the new trust should exempt the sale from the transfer-for-value rule.

## **Conclusion**

The list of tax issues described above is by no means exhaustive. It is intended to point out the unique tax rules applicable to life insurance contracts and to raise the levels of awareness and caution needed by advisors when dealing with a client's life insurance policies. Advisors can be proactive in this area by performing a "policy audit" to look for mistakes in ownership and beneficiary designations, problems with loans or erroneous transfers. Fortunately, many of these errors can be cured.

## **Endnotes**

1. Code Sec. 56(g) and Reg. 1.56(g)-1(c)(5). (Example 2)
2. Reg. 1.71-1T (b), Question and Answer No. 6
3. Revenue Ruling 61-134
4. Regulation 20.2042-1(c)(6) may trigger estate taxation if the insured were a controlling shareholder.
5. Estate of Goodman vs. Commissioner, 156 F 2d 218 (Second Circuit, 1946)
6. Siskin Memorial Foundation, Inv. vs. US 790 F 2d 480 (6<sup>th</sup> Circuit 1986), PLR 8028002, PLR 7918095 and Kern County Electrical Pension Fund v. Comm., 96 TC 845 (1991)
7. Regulation 1.1001-2
8. Code Sec. 101(a) and PLR 8951056
9. Regulation 1.1015-4
10. Internal Revenue Code Sec. 7702A(a)
11. TAMRA 1998 (P.L. 100-647) Conference Report, reprinted in 1988-3 CB 587

12. Monroe vs. Patterson, 197 F. Supp. 146(ND Ala 1961) and PLR 8906 034
13. Code Sec. 101(a)(2)
14. Code Sec. 1035
15. TAM 95 42 037, July 21, 1995
16. Regulation 20.2042-1(b)(1)
17. Revenue Ruling 85-13

**CAVEAT**

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