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ADVANCED MARKETS INSIGHT

Common Life Insurance Mistakes

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Through careful and thoughtful planning, life insurance can accomplish many important financial objectives. Life insurance can be used to transfer assets from one generation to the next free of tax, provide a tax-free benefit to employees, or indemnify a business from loss. However, if improperly managed, policy proceeds may be inadvertently subject to estate, gift, or income tax. Understanding life insurance products and tax laws, as well as how to avoid planning mistakes, will help to maximize the value of the life insurance asset.

Improper Policy Ownership & Beneficiary Designations

The most common planning mistakes involve the most fundamental component of a life insurance arrangement: designating the policyowner and beneficiary(ies).

Inclusion in Taxable Estate

The simplest arrangement is for the insured to own the policy, naming the insured's estate as beneficiary. Unfortunately, this structure results in the life insurance proceeds being included in the taxable estate of the insured, exposed to the claims of creditors. In addition, policy proceeds will be subject to the probate process, which can be both expensive and time consuming.

In the event a non-estate beneficiary predeceases the policyowner, and no contingent beneficiary is named, policy death benefits may also be paid to the insured's estate. This problem can be easily avoided by naming contingent beneficiaries on the policy application.

Forgoing Incidents of Ownership

In order to avoid inclusion of life insurance policy proceeds in the taxable estate, the insured may choose to have the policy owned by their adult children, forgoing any incidents of ownership. While the policy is removed from the estate, potential negative consequences exist, including:

- A loss of control over the policy, including the ability to name the policy beneficiary(ies).
- A lack of creditor protection for the children, potentially exposing policy cash values to the claims of the children's creditors.
- A potential gift tax impact on the insured parent who opts to pay future policy premiums.

A variation on this approach involves naming a spouse as owner and a child as a beneficiary. This situation can create an undesirable tax trap, known as the Goodman Triangle. When the owner, insured, and beneficiary are all different parties, the death benefit proceeds in the policy may be considered a taxable transfer from the owner to the beneficiary. For this reason, it is important that if the insured is not the owner, the owner and beneficiary are the same.

Irrevocable Life Insurance Trust

An irrevocable life insurance trust (ILIT) is commonly used to keep life insurance proceeds out of the taxable estate, while ensuring the estate has a necessary amount of liquidity to meet any outstanding obligations at death, including the payment of estate taxes. It is generally best for the trust document to allow the trustee to apply for, own, and be the beneficiary of the insurance policy.

Transferring an existing policy to a trust can have adverse tax consequences:

- A gift of a policy or funds to an ILIT is a taxable event.
- A policy gifted to a trust within three years of death will be included in the taxable estate of the decedent.

Transfer-for-Value

The "transfer-for-value" problem occurs when interest in a life insurance policy is transferred to another party in exchange for "valuable consideration." In most circumstances, life insurance death benefits are payable free of income tax. However, if the transfer-for-value rule is violated, the death benefit proceeds are taxable.

A transfer of the ownership of a policy does not have to occur for a transfer to take place. A transfer-for-value violation can be triggered by naming someone as the beneficiary in exchange for valuable consideration.

Consideration is broadly defined. While it is clear that a transfer-for-value violation occurs when an individual transfers the ownership of his or her policy in exchange for cash, money does not need to change hands for the rule to apply. A mutual promise can be enough to cause the transfer-for-value rule to apply.

Transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder are exceptions to the rule. Under these circumstances, death benefit proceeds will generally not be subject to income tax.

1035 Exchanges

Section 1035 of the Internal Revenue Code (IRC) states that no gain or loss shall be recognized on the exchange of a contract of life insurance for a) another contract of life insurance, b) an endowment,[1] c) an annuity contract, or d) a qualified long-term care insurance contract.

Because the intent of Section 1035 is to allow for tax deferral, rather than tax elimination, an annuity or endowment may not be exchanged for a life insurance policy. If an annuity or endowment is exchanged for a permanent life contract, any gain in the contract at the time of exchange would be currently reportable.

1035 Exchanges of Policies with Outstanding Loans

In most circumstances, replacing a life insurance policy with a new life insurance policy will result in the policyholder owning a new contract with a basis equal to that of the original contract and the deferral of the recognition of any taxable gain. However, the IRS has described circumstances where the policyholder receives a new insurance policy as well as some additional payment of cash or other property as a result of the exchange. The IRS refers to these additional amounts as "boot." If the policy holder receives "boot" in an otherwise tax-free exchange, gain will be recognized to the extent of the boot received.

For this reason, life insurance policies with outstanding policy loans require special care during the exchange process in order to avoid adverse tax consequences.[2] The policyholder has two options when exchanging a policy with an outstanding loan:

1. Pay off the loan before the exchange. The original policy may have sufficient cash value available for withdrawal or partial surrender that can be used to pay off an existing policy loan. However, when this approach is used in close proximity to a 1035 exchange, the IRS may regard the repayment of the loan and the 1035 exchange as one integrated transaction, deeming the amount of the loan that was paid off as "boot." It is therefore advisable to either use a source of funds outside of the policy cash values to repay the loan or wait a reasonable period of time before initiating a 1035 exchange.

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1 An Endowment contract is defined as a contract with an insurance company that depends, in part, on the life expectancy of the insured, but that may be payable in full in a single payment during the insured's life.

2 IRC sections 1031(b) and (c); see also Rev. Rule 2003-56, and Private Letter Rulings 9141025 and 8905004.

2. Carry the loan over. Most insurance carriers will allow the policyowner to acquire a new policy subject to the same indebtedness as the original policy while preserving tax deferral under Section 1035.[3] If the policyowner allows sufficient time to pass, the loan can be repaid using a withdrawal of basis from the new policy. Although there is no specific guidance from the IRS as to how much time must elapse before the repayment of the loan using policy values will be seen as a separate transaction, some insurance carriers will treat withdrawals within the first policy year of a new policy issued with a loan as a taxable distribution.

Modified Endowment Contracts

Life insurance policies that fail to meet the definition of life insurance under Section 7702 of the Internal Revenue Code will be reclassified as Modified Endowment Contracts (MECs). Once a contract has been classified as a MEC, it will forever be deemed a MEC, and any contract it is exchanged for will be deemed a MEC.

In addition to being subject to MEC testing at policy inception, the seven-pay test will be re-administered upon the occurrence of any event that materially modifies the life insurance contract. Such modifications may include, but are not limited to:

- A reduction or increase in the policy's death benefit.
- A conversion of a term policy to a permanent life policy.
- An exchange of a permanent life policy for another life policy, whether or not the exchange is tax free under Section 1035.

Consequences of a MEC

- Lifetime distributions from MECs are taxable as ordinary income until the distributions exceed the gain in the MEC (i.e., on a Last In, First Out basis).
- Policy loans and pledges of MECs as collateral for loans are taxed as MEC distributions.
- A 10% penalty is imposed on the includible amount of the MEC distribution, with limited exceptions (e.g., the MEC owner is disabled or over age 59½).

Summary

The proper management and administration of life insurance policies is critical to avoid unintentional gift, estate, and income taxation. It is important to consult with an experienced life insurance professional who can provide the insight and experience necessary to produce successful results.

3 Private Letter Rulings 8806058 and 8816015.

For More Information

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