Income Taxation of Life Insurance and Annuity Contracts

Life insurance and annuity contracts have long been perceived as serving a valuable socioeconomic function. Policyholders are protected against the financial consequences of dying too soon or of living too long. The families of those who obtain these types of insurance may continue to lead financially independent lives.

Death Proceeds of Life Insurance

The recognized public benefits of life insurance and annuity ownership have led to their favorable treatment under the tax laws. Under Sec. 101 of the Internal Revenue Code, most life insurance death benefits are income tax free. But if a policy has been transferred for value, the portion of the death benefit which represents gain may be taxable.

A "transfer for value" occurs when an owner transfers a life insurance policy in exchange for something of value (unless the transfer falls into an exempt class). An actual sale of the policy is not necessary. Any promise or agreement providing for a right to receive the policy proceeds in exchange for value (e.g., property or personal services) results in a "transfer for value." For example, if a policy is transferred without any cash changing hands, but the policy is subject to a loan that exceeds the cost basis, then a transfer for value has occurred. Moreover, if the policyowner agrees, for a valuable consideration, to name a third party as beneficiary of all or part of the death proceeds, then a transfer for value occurs even though no actual assignment of the policy has taken place.

A gift of a policy is not a transfer for value. A gift is a gratuitous transfer motivated by detached and disinterested generosity. In gift situations, the donee "steps into the shoes of the donor." If the proceeds would have been exempt to the donor, they will be exempt to the donee. This is known as the basis carryover exception to the transfer for value rule. The donee must not exchange anything of value for the gift, however, or a transfer for value will have occurred, unless the transferee is one of the excepted persons set forth in the table following:

Transfers for Value

Policy Owner and Transferor	Transferee for Value	Tax Result
Anyone	Insured	Proceeds income tax-free
Anyone	Partner of insured	Proceeds income tax-free
Anyone	Partnership in which insured is a partner	Proceeds income tax-free
Anyone	Corporation in which insured is a shareholder or officer	Proceeds income tax-free
Anyone	Anyone where basis is determined by reference to transferor's basis	Proceeds income tax-free
Anyone	Co-shareholder	Proceeds not income tax-free
Anyone	Anyone else	Proceeds not income tax-free

Most common transfer for value problems arise in business insurance situations involving key employee or buy-sell policies. The preceding table summarizes the rules that apply in transfer-for-value situations (pension plans are subject to special rules).

Death benefits may also be taxable if the proceeds are received from a policy in a qualified plan, if proceeds are received through a corporation as compensation or dividends, if received by a creditor on the life of a debtor, or if there is no insurable interest in the life of the insured. Proceeds received by corporations may also be subject to alternative minimum tax, if applicable.

Life insurance policy transfers between spouses do not trigger the transfer for value rule even if something of value (valuable consideration) is involved. IRC Sec.1041(a). The transfer of a policy incident to a divorce is also exempt from the transfer for value rule if the transfer is within one year of the end of the marriage [IRC Sec.1041(c)].

Both the transfer between spouses and the transfer between former spouses come under the basis carryover exception to the transfer for value rule [IRC Sec.101(a)(2)(A)].

In a situation where a Taxpayer created two grantor trusts, and proposes that the trustee of Trust 1 transfer a life insurance policy owned by Trust 1 to the trustee of Trust 2 for a valuable consideration, the IRS ruled that the transfer will be disregarded for federal income tax purposes. The Taxpayer is treated as the owner of all the assets in both trusts.Rev. Rul. 85-13, 1985-1 C.B. 184. The Taxpayer wants Trust 2 to purchase the policy from Trust 1. The IRS ruled that the transfer of the policy will not affect the tax-free character of the death proceeds upon the death of the Taxpayer.PLR 200518061.

The Pension Protection Act of 2006 added rules regarding the federal income taxation of death proceeds where a company owns life insurance on an employee. Click here for a discussion of these rules.

Certain qualified accelerated death benefits which are paid before the death of a terminally ill insured may be exempt from income taxation under IRC Sec. 101, even though paid prior to death, if certain requirements are met.

Annuity Death Benefits

Death benefits paid to beneficiaries of annuity contracts will be included in taxable income to the extent that they exceed the basis of the decedent in the annuity contract at the date of death. If the beneficiary elects, within one year of death, to receive a life income or installment option, then he or she will be taxed under the annuity rules.

Lifetime Payments

Lifetime payments from life insurance and annuity contracts are taxed under favorable rules. These rules, however, have grown increasingly complex in recent years. The starting place for taxation of lifetime payments is IRC Sec. 72. Contributions to annuities prior to August 14, 1982 are taxed on the basis that withdrawals come from principal first and then interest, unless a life insurance or annuity contract is paid as an annuity under Sec. 72, in which case basis is recovered pro rata over the life expectancy of the annuitant.

Congressional concern that life and annuity contracts were being abused as tax-sheltered investment vehicles led to the adoption of an interest-first rule for taxing distributions from annuity contracts issued after August 13, 1982. This means that, to the extent that contract values exceed the amount invested in the contract, distributions from that contract will be taxable as ordinary income to the policy owner. "Interest first" is the descriptive term for this approach. Also, annuity withdrawals prior to age 59½ will be subject to a 10% federal income tax penalty, unless an exception applies.

Section 72(e)(5)(C) of the Internal Revenue Code provides that life and endowment contracts will continue to be taxed under the old cost-recovery rules, subject to regulations to be issued by the IRS. However, the traditional taxation of lifetime benefits from life insurance policies has been substantially altered by Internal Revenue Code Sections 7702 and 7702A.

Section 7702 requires life insurance policies to meet certain guideline premium and cash accumulation tests in order to qualify for taxation as life insurance policies. Policies which fail to meet these tests will lose the tax benefits of classification as life insurance policies.

Section 7702A imposes a less favorable classification on certain life insurance contracts which meet the requirements of Sec. 7702, but fail to pass the "7-Pay test" set out in Sec. 7702A. Such contracts are classified as "Modified Endowment Contracts" (MECs) and are taxed not under the usual cost-recovery, but under the interest-first approach used for annuities issued after August 13, 1982.

The 7-Pay test is aimed at discouraging the sale of large single-premium life insurance contracts designed to be used as tax-sheltered investment vehicles. In order to avoid classification as a MEC, policy premiums must be small enough in amount and sufficiently spread out in time, that they are able to pass the 7-Pay test.

Lifetime payments received under life insurance and annuity contracts may be "amounts received as an annuity," or "amounts not received as an annuity," or amounts received as interest. All of the various types of lifetime payments which a policyholder may receive are treated as falling into one of these categories.

Amounts received as an annuity. Fixed annuities are taxed by excluding from taxation a pro-rata percentage of the "investment in the contract" from each of the payments received during the life expectancy of the annuitant. The number of payments anticipated must be calculated. Where there is a measuring life or lives, an expected return multiple found in IRS life expectancy tables is used. The applicable number is multiplied by the amount of each payment.

Example – Joe is 67 years old. He has paid annuity premiums of $200,000 and will receive lifetime annuity payments of $17,500. From IRS Table V we see that his life expectancy is 18.4 years. His exclusion ratio is calculated as follows:

$$\frac{\$200{,}000 \text{ investment in the contract}}{\$322{,}000 \text{ expected return } (\$17{,}500 \times 18.4)} = 62\%$$

Each payment will be part tax free and part ordinary income or $10,850 tax free ($17,500 × .62) and $6,650 ordinary income.

Amounts received as an annuity. Variable annuities enjoy the same tax free cost recovery that fixed annuities get. The tax free portion of the variable annuity is not determined by the use of an exclusion ratio since the amount of each payment is unknown. The investment in the contract is divided by the number of years payments are to be made. If payments are for life, the IRS tables should again be used.

Example – Susan is 65 and has paid annuity premiums of $300,000. Her life expectancy is 20 years, using IRS Table V. Since she purchased a variable annuity, the amount of her expected return is unknown. We simply divide her investment in the contract by her life expectancy.

$$\frac{\$300{,}000 \text{ investment in the contract}}{20 \text{ years life expectancy}} = \$15{,}000$$

She will exclude $15,000 of each annuity payment from income until she has recovered her investment in the contract.

This product is referred to as the expected return. The investment in the contract (adjusted basis if an existing policy) is divided by the expected return to arrive at a percentage known as the exclusion ratio. This percentage of each payment will not be income-taxed until the investment in the contract is recovered. Payments received after the annuitant's investment in the contract has been recovered (when the annuitant outlives life expectancy) are fully taxable. Investment in the contract not recovered at the annuitant's death can be deducted on the individual's final income tax return.

Amounts not received as an annuity include dividends, loans, withdrawals, and surrenders. If a life insurance policy is not a MEC, loans are received free of tax, as long as the policy does not lapse. Lapse of a policy with outstanding loans in excess of basis will cause taxable gain to be recognized to the extent that loans and other distributions exceed basis. Such a tax event unaccompanied by real income produces what is often called "phantom income."

Dividends, withdrawals, and surrenders from non-MEC life policies will be taxed under the cost-recovery rule (tax-free until basis is exceeded) unless a "force-out" under Sec. 7702 is triggered, usually by a policy distribution followed by a reduction in benefits. For example, if no force-out is involved, dividends from participating life insurance contracts are seen as a return of capital, and are income-tax free until basis has been exceeded.

Section 7702 is technical enough in its application to policy changes that warning triggers are often built into illustration software to indicate a potential problem. Policy service people in company home offices often work with company actuaries to develop procedures which minimize the likelihood that Sec. 7702 will be inadvertently violated by policyholders. Policy transactions, particularly with respect to cash-rich policies, should be carefully monitored to avoid Sec. 7702 force-out problems.

Any amounts not received as an annuity which are taken from a MEC will be taxed as distributions under the interest-first approach.

Premature withdrawal penalties may also apply, just as they do to annuities, if withdrawals are made prior to the owner reaching age 59½. Unlike non-MECs, distributions from MECs also include assignments and transfers.

Policy loans secured by life insurance policies which are not MECs are not treated as distributions and are not taxable, even if loan amounts exceed basis in the contract. However, if the policy lapses or is surrendered with an outstanding loan, the loan is immediately taxable to the extent of gain in the contract. In contrast, loans taken from policies which are MECs are deemed to be distributions, and are taxable to the extent of gain in the contract. A 10% penalty tax will also be levied, unless an exception applies.

Interest on policy loans is generally personal interest, and as such is non-deductible. It is uncertain whether in some circumstances interest on loans taken out to purchase a life insurance policy may be deductible as investment interest.

Settlement Options

Under normal circumstances death proceeds payable to the beneficiary of a life insurance policy are received income-tax free. Most insurance policies provide for alternatives to a lump-sum payment to the beneficiary. These alternative plans are collectively referred to as settlement options.

Most settlement option payments involve two elements: a principal element (part of the lump-sum death proceeds which would have been paid) and an interest element (reflecting the interest earned by proceeds held by the insurance company). The interest portion of any payment under a settlement option is taxable; the portion representing the original death benefit is federal income tax-free.

Common settlement options include:

• fixed-period option

• fixed-amount option

• interest-only option

• life-income options—may include joint and survivor, period certain, or guaranteed refund options.

Interest-only option payments will not include a non-taxable portion, since only interest is being paid out. Even interest which is accumulated and not paid out will be taxed under the doctrine of constructive receipt. Under this legal concept, tax is levied because even though the person did not receive an amount, he or she had the right to receive it. For annuities under the interest-only settlement option, all gain in the contract becomes taxable at maturity even though the proceeds are left with the company.

Section 1035 Exchanges

The tax-free exchange of old policies for new is a frequent occurrence, often motivated by a policy owner's desire to obtain higher rates of return or lower mortality costs.

The replacement of any old policy with a new one is governed by a variety of state laws and regulations, with which insurance professionals should carefully comply.

In buying a new policy, a client will incur new acquisition costs, which may mean that even a clearly superior new policy may not be better for a client until many years have passed.

Existing coverage should be carefully compared with reasonable projections of new policy values and benefits, and pros and cons carefully considered, before a change is made.

Provided that the owner, insured, or annuitant are the same before and after the transaction, Section 1035 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of:

• a contract of life insurance for another contract of life insurance or an endowment or annuity contract (owner and annuitant must be the same); or

• a contract of endowment insurance (1) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (2) for an annuity contract (owner and insured must be the same); or

• an annuity contract for an annuity contract (owner and annuitant must be the same).

Section 1031(b) of the Internal Revenue Code provides that gain from exchanges "not solely in kind" will be taxable.

The cautious interpretation of Sec. 1031(b) is that when a policy to be exchanged secures a policy loan, then the amount of that loan will be taxable up to the amount of gain on the contract.

If a policy to be exchanged has an outstanding loan, and if there is gain on the contract, the most common ways to avoid having to recognize taxable gain are either to pay off the policy loan prior to the exchange, or to arrange for the new carrier to assume the existing policy loan.

In either case, clients should be encouraged to consult their tax advisors.

To qualify as a legitimate Sec. 1035 exchange, an exchange of policies must take place. Company procedure should be carefully followed. A sale-and-purchase is not an exchange.

In Private Letter Ruling 9542037, the IRS discussed four different situations involving exchanges by policyholders who are spouses.

Situation 1: A husband exchanges a life insurance policy insuring his life for a second-to-die contract covering him and his wife.

Situation 2: A husband exchanges two life insurance contracts – one on his life and one on his wife (husband was owner of both contracts) for a second-to-die contract insuring both husband and wife.

Situation 3: Husband and wife own separate contracts on their own lives which were exchanged for a jointly owned second-to-die policy.

Situation 4: The facts are the same as Situations 1 and 2 except that a trust is owner and the exchanger.

In none of the situations do the spouses or the trust receive any money or other property.

The IRS ruled that none of the exchanges qualified as a tax-free exchange under IRS Sec. 1035. In citing the Income Tax regulations, the IRS noted that Sec. 1035 does not apply if the policies exchanged do not relate to the same insured. Reg. Sec. 1.1035-1. In other words, an exchange that results in an insured in addition to the original insured does not qualify for Sec. 1035 treatment.

In a situation involving a Business Exchange Agreement where the contract allowed the corporate owner to change insureds, the IRS ruled that the exchange did not qualify under Sec. 1035. Rev. Rul. 90-109. 1999-2 C.B. 191.