Advanced tax time planning: 15 life insurance considerations

Life insurance is a unique asset with distinct taxation issues

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Life insurance can be a superb savings asset, but it does carry distinct tax issues.

All conventional saving vehicles serve the same purpose, but the unique feature of life insurance is that it assures a desired accumulation at a specific, but uncertain time; namely at the time of the insured's death. No other savings or investment tool makes such a guarantee.

Here are 15 life insurance tax issues to anticipate in advance of filing time, from "The Tools & Techniques of Life Insurance Planning" (6th Edition).

No 15: Gift taxes
Premium payments by an owner-insured on a policy that names someone other than the insured or the insured's estate as beneficiary generally are not considered gifts for gift tax purposes.

However, gift tax law does treat premium payments by anyone other than the policy owner as gifts and those payments may be subject to gift tax to the extent they exceed the payer's annual exclusion ($14,000 in 2017 as indexed for inflation). Such premiums generally qualify for the annual exclusion.

No. 14: Beneficiary questions
Death benefits paid to someone other than the owner-insured or the owner-insured's estate are generally not treated as gifts for gift tax purposes.

No. 13: Incidents of ownership
The estate of the insured will include the proceeds of a life insurance policy for federal estate tax purposes if the insured held "incidents of ownership" at any time during the three years prior to death or if the proceeds from the policy were payable to or for the benefit of the estate of the insured.

Incidents of ownership include:

- Change the beneficiary
- Take out a policy loan
- Surrender the policy for cash

No. 12: Alternative Minimum Tax

Proceeds from corporate-owned life insurance policies paid to the corporation may generate an Alternative Minimum Tax (AMT). Under a worst case scenario, this tax could amount to roughly 15 percent of the total policy proceeds paid to a corporate beneficiary.

The AMT is basically an alternative tax calculation that assures a corporation pays at least a minimum amount of tax if certain "preferred" types of income that are excludable for regular tax purposes or special deductions reduce the regular income tax "too much."

No. 11: Private sales
In general, life insurance death proceeds are not subject to federal income taxation.

However, life insurance policies that have been sold from one policy owner to another may be subject to the transfer for value rule.

Under this rule, the portion of the death proceeds in excess of the sum of the purchase price and any premiums paid after the transfer is subject to taxation as income. In other words, if an existing life insurance policy or an interest in an existing policy is transferred for any type of valuable consideration in money or money's worth, all or a significant portion of the proceeds may lose its income-tax-free status when the insured dies.

However, certain transfers fall within a safe harbor to the rule and therefore remain exempt from income tax. Under these safe harbor exemptions, policy owners can safely transfer policies to:

1. The insured;
2. A partner of the insured;
3. A partnership in which the insured is a partner; or
4. A corporation in which the insured is a shareholder or officer, without subjecting the policy proceeds to income tax under the transfer for value revalue rule.

There is an additional safe harbor exception for transfers where the transferee's basis is determined in whole or in part by reference to its basis in the hands of the transferor (e.g. transfers that constitute–at least in part–gifts).

No. 10: Interest expense
Interest paid on policy loans used for investment purposes is subject to different deductibility limits. In general, the interest on all the taxpayer's loans, including life insurance policy loans, used to finance investments is deductible each year but only to the extent it does not exceed the taxable investment income from all investments. If interest expense exceeds investment income in one year, the taxpayer carries the excess forward and may deduct the excess interest in future years when the taxpayer has adequate investment income.

No. 9: Personal interest
In general, if a policy owner uses policy loans to pay premiums on the policy or for any other personal purpose other than to finance an investment or for business use, the interest is subject to the personal interest limitations.

No. 8: What is deductible?
Any interest paid or accrued on debt with respect to corporate-owned life insurance or annuity or endowment contracts generally is not deductible. This rule bars the deduction for interest even if the deduction would not be disallowed under any other rule (e.g., the four-out-of-seven rule). (See Chapter 24 for a further discussion of deductibility of policy loan interest.)

For policies purchased before June 21, 1986, the limitation on the deduction does not apply. However, the IRS has privately held that interest on contracts governed by prior law had to be valid interest to be deductible; that is, paid for the use or forbearance of money for a valid underlying debt obligation. According to the IRS, policies with a high premium structure together with loading dividend and partial withdrawal mechanisms served no economic purpose and did not produce debt for tax purposes.

Generally, even if a policy qualifies under the exception described above, the interest paid on loans secured by a key employee life insurance policy is not deductible unless one or more of the following exceptions are met:

- “Four out of seven” exception — At least four of the first seven annual premiums are paid without recourse to policy loans.
- “$100 a year” exception — If the interest does not exceed $100 for any taxable year, the interest deductions will not be disallowed even if there is a systematic plan of borrowing.
- “Unforeseen event” exception — If the debt was incurred because of an unforeseen substantial loss of income or substantial increase in obligations, the deduction will not be disallowed even though the policy loan was used to pay premiums.
- “Trade or business” exception — If the debt is incurred in connection with the client’s trade or business, the interest deduction will not be disallowed.

No. 7: Policy loans
Policy loans, except from modified endowment contracts, generally are not treated as taxable distributions, even if the loan exceeds the policy owner’s cost basis in the policy.

No. 6: Distributions
Distributions or withdrawals under the contract at any time before death from policies that are classified as Modified Endowment Contracts (MECs) are taxed under the interest-first rule, even if they are not accompanied by a reduction in the face amount of coverage. In addition, if such distributions are received before age 59½, the taxable portion may be subject to an additional 10 percent penalty tax.

No. 5: LIFO
A withdrawal of cash values within the first fifteen policy years may be taxed on a last-in, first-out basis (LIFO), or under what is called the interest-first rule, if a reduction in the face amount of coverage accompanies the withdrawal. Specifically, in these cases a withdrawal will be taxable to the extent of gain in the policy. The excess is then treated as a nontaxable recovery of basis in the policy.

No. 4: FIFO
Withdrawals of cash values, when permitted, usually are taxed on a first-in, first-out (FIFO) basis, or under what is called the cost-recovery rule. Specifically, a withdrawal is considered to be a nontaxable recovery of cost basis or premiums until the policy owner’s entire cost basis has been withdrawn. Only then are additional withdrawals treated as taxable distributions of interest or gain in the policy.

No. 3: Cash value increases
Cash value buildup in a life insurance policy generally enjoys an indefinite deferral from income taxation while it remains in force and an exemption from income taxation if the policy terminates in a death claim. However, if the policy is surrendered for cash, gain on the policy is subject to federal income taxation. Gain on a surrendered policy is the amount by which the net cash value payable plus any policy loan forgiven exceed the owner’s basis in the policy. Basis in the policy equals the premiums actually paid in cash less policy owner dividends and withdrawals recovered tax free, if any.

No. 2: Dividends

Dividends received by the policy owner generally are not subject to federal income taxation. Dividends are not usually taxable income until the aggregate of dividends paid exceeds the aggregate of premiums paid by the policy owner.

No. 1: Premium payments

In general, the tax law does not permit policy owners to deduct premium payments on life insurance policies. Notable exceptions are for premium payments for group life insurance provided by an employer for employees and for “bonus” payments to employees for payment of premiums under Code Section 162 plans.