Life Insurance & Modified Endowments, 2nd ed.

Chapter 1: Introduction

Desrochers, et al. (2015)

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Key Exam Topics in This Lesson

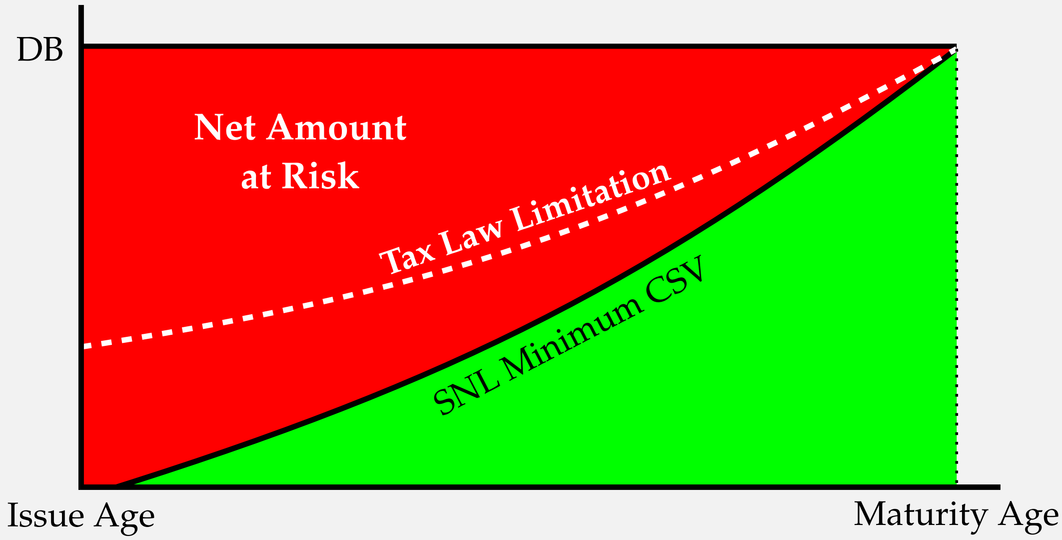
- Income Tax Treatment of Life Insurance Contracts
  - Insurance vs. Investment Orientation
  - Overview of Death Benefit Tax Treatment
  - Inside Buildup and Lifetime Distributions
  - Distribution Taxation Quizzes
  - Tax Treatment of Other Events
- Legislative History of Life Insurance Taxation
  - Pre-7702: Common Law Rules and TEFRA
  - DEFRA (7702) and TAMRA (7702A)
  - Classes of Life Insurance Created by 7702 and 7702A
  - Applicable Law Requirement in Section 7702
  - Terminology Used in Interpreting Tax Law

This handout sample includes the first part of this lesson only. The remaining slides are included in the online seminar.

Insurance vs. Investment Orientation

U.S. tax law limits the investment orientation of life insurance

IRS grants favorable tax for CSV, but CSV can only be so high



Overview of Death Benefit Tax Treatment

Full DB is tax-free under §101(a) if there is an insurable interest

- Insurable interest may not exist for
  - Employer-owned life insurance (COLI)
  - Transfers for value (e.g. life settlements)
- If DB is annuitized, the DB proportion of payments (level %) is not taxed

$$\frac{\text{DB}}{\sum \text{Expected Annuity Payments}} = \text{Non-Taxable \% of Each Payment}$$

Accelerated DBs are also generally tax-free

- Covered in Ch. 7

Inside Buildup and Lifetime Distributions

Lifetime distributions result when CSV is brought outside the contract before death

- Surrenders (partial or full), policy loans, dividends, maturities

7702 and 7702A determine how the inside buildup is taxed before death

- Never taxed on a 7702-compliant contract if CSV stays inside through death
- If a distribution occurs, taxation depends on MEC status (7702A)
  - Non-MECs: FIFO (best) – cost basis comes out first
  - MECs: LIFO (worst) – gains come out first
    - Additional 10% penalty tax on the gain
    - Policy loans trigger gains just like surrenders (never for non-MECs)
    - Taxed portion of policy loan increases investment in the contract
- Gain inside the contract = 7702 CSV − Investment in the Contract
  - Inv. in the Contract = Premiums Paid − Previous Distributions Excl. From Income
  - CSV ignores surrender charges and policy loans
  - Actual surrender charges incurred are netted out of policy gain

Quiz 1: Full Surrender

Suppose a non-MEC policy has a $10,000 cash value, and the investment in the contract is $7,000. The policyholder's income tax rate is 25%.

The policyholder surrenders the contract in full.

1. Calculate the after-tax proceeds received by the policyholder
2. Redo #1 assuming there is also a $2,000 policy loan outstanding
3. Redo #2 assuming there is also a 5% surrender charge

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Quiz 1: Full Surrender

In all 3 cases:

- After-tax proceeds = amount received − taxes
- Taxes = tax rate × net gain received − investment in the contract

Scenario 1:

- Taxes = 25% × (10,000 − 7,000) = 750
- After-tax proceeds = 10,000 − 750 = $\boxed{9{,}250}$

MEC calculations would use a 35% tax rate if under $59\frac{1}{2}$

Scenario 2:

- Same as scenario 1
- Policy loan is included as amount received
- *It's like the loan is not formally brought outside until surrender*

Scenario 3:

- Taxes = 25% × (0.95 × 10,000 − 7,000) = 625
- After-tax proceeds = 9,500 − 625 = $\boxed{8{,}875}$

Quiz 2: Treatment of Partial Withdrawal – MEC vs. Non-MEC

Suppose a policy has a \$5000 cash surrender value, and the policyholder has paid \$4000 in premiums. There have been no past withdrawals, and there are no surrender charges. The policyholder takes a partial surrender of \$3000.

Calculate the gain and impact on investment in the contract for both:

1. A non-MEC
2. A MEC

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Quiz 2: Treatment of Partial Withdrawal – MEC vs. Non-MEC

For the non-MEC (compliant with 7702 and 7702A):

- Investment comes out first
- Taxable amount = 0 since \$3K distribution $<$ \$4K investment in the contract
- New investment in the contract = \$4K $-$ \$3K = \$1K
- Remaining gain inside contract = \$2K $-$ \$1K = \$1K (same gain as before)

For the MEC (compliant with 7702 but not 7702A):

- Gains come out first $\Rightarrow$ \$3K distribution = \$1K of gain and \$2K of investment
- Taxable amount = \$1K (the gain portion)
- Will also have to pay 10% penalty tax on the \$1K gain
  - If tax rate was 25%: tax = 25% $\times$ 1K + 10% $\times$ 1K = \$350
- New investment in the contract = \$4K $-$ \$2K = \$2K
  - The \$2K reduction is the portion not included in income (investment portion)
- Remaining gain inside contract = \$2K $-$ \$2K = 0 (since all gain was distributed)

Quiz 3: Treatment of Policy Loan – MEC vs. Non-MEC

Redo the Quiz 2 assuming the \$3000 distribution was a policy loan instead of a partial surrender.

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No peeking!

Quiz 3: Treatment of Policy Loan – MEC vs. Non-MEC

For the non-MEC (compliant with 7702 and 7702A):

- Policy loans are never taxed while the contract is in force
- No impact on investment in the contract or gain

For the MEC (compliant with 7702 but not 7702A):

- Distribution is identical to partial withdrawal = \$1K gain + \$2K investment
  - Will pay the same 10% penalty tax as a surrender
- Add taxed portion of policy loan to investment to prevent future taxation
- New investment in the contract =

  \$4K original investment
  + \$1K taxed portion of policy loan
  = \$5K investment in the contract after policy loan
- Remaining gain inside contract = \$5K − \$5K = 0 (same net effect as surrender)

Quiz 4: Policy Loan Applied as Premium Payment

Redo Quiz 3 assuming the $3000 policy loan was used to make a premium payment of the same amount.

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No peeking!

Quiz 4: Policy Loan Applied as Premium Payment

For both the MEC and non-MEC:

- Any form of premium increases investment
- Assume CSV also increases dollar for dollar: 5K + 3K = 8K

Non-MEC:

- New investment in the contract = 4K + 3K = 7K
- Gain inside contract is unchanged from Quiz 3 at 1K

MEC:

- New investment in the contract = 5K + 3K = 8K
- Gain inside contract is unchanged from Quiz 3 at 0

Tax Treatment of Other Events

- **Premiums paid and interest paid on policy loans** – not tax deductible
- **1035 contract exchanges** – does not trigger taxable gain
  - Cost basis carries over
  - Works for any combination of life, annuity, or QLTCI contract exchanges
- **Contract sales** (e.g. life settlements)
  - Seller's taxable gain = price received − cost basis
  - Cost basis = premiums paid − cumulative cost of insurance
  - Buyer's cost basis = price paid + future premiums − future untaxed distributions
- **Gifted life insurance** – always tax-free
- **Deduction of loss on surrender or sale** – not tax deductible