Taxation Of Life Insurance And Annuities - Premiums And Proceeds

This section will help broaden your knowledge of life insurance and annuities by explaining the subject of taxation. You will learn the basic principles of taxation of policy benefits, dividends, and loans, as well as options available for nontaxable exchanges.

TERMS TO KNOW

FIFO (First In, First Out) — principle under which it is assumed that the funds paid into the policy first will be paid out first
Gross income — a person's income before taxes or other deductions
LIFO (Last In, First Out) — principle applied to asset management in life insurance products, under which it is assumed that the funds paid into the policy last will be paid out first
Pretax contribution — contribution made before federal and/or state taxes are deducted from earnings
Surrender — early termination of a policy by the policyowner
Tax deductible — a reduction of taxable income, resulting in lower tax liability
Taxable — subject to taxation, payable to state and federal government
Tax deferred — taxes on investments or gains (such as interest or dividends) are paid at a future date instead of in the period in which they are incurred tax

A. Taxation Of Life Insurance

Educational Objective:

II.F.1. Be able to identify the tax treatment regarding:

a. Premium payments
b. Cash value accumulation or dividends
c. Death benefit proceeds
d. Surrender and mature policy values
e. Annuity payments to the annuitant or the beneficiary
f. Group life insurance
g. Internal Revenue Code (IRC) Section1035 exchanges

Generally speaking, the following taxation rules apply to life insurance policies:

- **Premiums** are not tax deductible; and
- **Death benefit:**
  - Tax free if taken as a lump-sum distribution to a named beneficiary; and

    - Principal is tax free; interest is taxable if paid in installments (other than lump sum).

1. Amounts Available to Policyowners

As you have already learned, permanent life insurance provides living benefits. There are several ways in which policyowners may receive those living benefits from the policy.

Dividends

Since dividends are a return of unused premiums, they are not considered income for tax purposes. When dividends are left with the insurer to accumulate interest, the interest earned on the dividend account is subject to taxation as ordinary income each year interest is earned, whether or not the interest is paid out to the policyowner.

Cash Value Accumulations

Any cash value accumulations in the policy can be borrowed against by the policyowner, or may be paid to the policyowner upon surrender of the policy. Cash values grow tax deferred. Upon surrender or endowment, any cash value in excess of cost basis (premium payments) is taxable as ordinary income. Upon death, the face amount is paid, and there is no more cash value. Death benefits generally are paid to the beneficiary income tax free.

Policy Loans

The policyowner may borrow against the policy's cash value. Money borrowed against the cash value is not income taxable; however, the insurance company charges interest on outstanding policy loans. Policy loans, with interest, can be repaid in any of the following ways:

- By the owner while the policy is in force;
- At policy surrender or maturity, subtracted from the cash value; or
- At the insured's death, subtracted from the death benefit.

Know This! Policy loans from the cash value are NOT income taxable.

Surrenders

When a policyowner **surrenders** a policy for cash value, some of the cash value received may be taxable as income if the cash surrender value exceeds the amount of the premiums paid for the policy. When the owner withdraws cash value from a universal life policy (partial surrender), both the cash value and the death benefit are reduced by the surrender.

Example:

Consider the following scenario:

- Face amount: $300,000
- Premiums paid: $70,000
- Total cash value: $100,000

If the insured surrendered $30,000 of cash value, the full $30,000 would be income tax free. If the insured took out $100,000, the last $30,000 would be taxable because the $100,000 exceeds the premiums that were paid in by $30,000.

Accelerated Benefits

When accelerated benefits are paid under a life insurance policy to a terminally ill insured, the benefits are received **tax free**. When accelerated benefits are paid to a chronically ill insured (*for example*, someone who has cancer, Alzheimer's disease or other severe illness), these benefits are tax free up to a certain limit. Any amount received in excess of this dollar limit must be included in the insured's gross income.

2. Amounts Received by Beneficiary

General Rule and Exceptions

Life insurance proceeds paid to a named beneficiary are generally **free of federal income taxation** if taken as a lump sum. An exception to this rule would apply if the benefit payment results from a *transfer for value*, meaning the life insurance policy is sold to another party prior to the insured's death.

Know This! Lump-sum cash payment of life policy proceeds are tax free for the beneficiary.

Settlement Options

With **settlement options**, when the beneficiary receives payments consisting of both principal and interest, the interest portion of the payments received is taxable as income. *For example,* if $100,000 of life insurance proceeds were used in a settlement option paying $13,000 per year for 10 years, $10,000 per year would be income tax free and $3,000 per year would be income taxable.

Know This! In settlement options, the principal is tax free, but the interest is taxable.

PERMANENT LIFE FEATURES	TAX TREATMENT
Premiums	Not tax deductible
Cash value exceeding premiums paid	Taxable at surrender
Policy loans	Not income taxable
Policy dividends	Not taxable
Dividend interest	Taxable in the year earned
Lump-sum death benefit	Not income taxable

Know This! Taxes must be paid either upon contribution or upon distribution, NOT both (if taxed on one end, will not be taxed on the other).

3. Group Life and Employer-sponsored Plans

The **premiums** that an employer pays for life insurance on an employee, whereby the policy is for the employee's benefit, **are tax deductible to the employer** as a business expense. If the group life policy coverage is $50,000 or less, the employee does not have to report the premium paid by the employer as income (not taxable to the employee).

Any time a business is the named beneficiary of a life insurance policy, or has a beneficial interest in the policy, any premiums that the business pays for such insurance are not tax deductible. Therefore, when a business pays the premiums for any of the following arrangements, the premiums are not deductible:

- Key-employee (key-person) insurance;
- Stock redemption or entity purchase agreement; and
- Split-dollar insurance.

The **cash value** of a business owned life insurance policy or an employer provided policy accumulates on a tax-deferred basis and is taxed in the same manner as an individually owned policy.

Policy loans are not taxable to a business. Unlike an individual taxpayer, a corporation may deduct interest on a life insurance policy loan for loans up to $50,000.

Policy death benefits paid under a business owned or an employer provided life insurance policy are received income tax free by the beneficiary (in the same manner as in individually owned policies).

If the general requirements for qualified plans are met, the following tax advantages apply:

- Employer contributions are tax deductible to the employer, and are not taxed as income to the employee;
- The earnings in the plan accumulate tax deferred; and
- Lump-sum distributions to employees are eligible for favorable tax treatment.

4. Section 1035 Exchange

In accordance with Section 1035 of the Internal Revenue Code, certain exchanges of life insurance policies and annuities may occur as nontaxable exchanges. When a policyowner exchanges a cash value life insurance policy for another cash value life insurance policy, or a cash value life policy for an annuity, or an annuity for an annuity, the policies or annuities **must be on the same life**. There will be no income tax on these transactions.

The following are allowable exchanges:

- A life insurance policy for another life insurance policy, an endowment contract, or an annuity contract;
- An endowment contract for another endowment contract or an annuity contract; or
- An annuity contract for another annuity contract.

Note that a policyowner may not exchange funds from an annuity into a cash value life policy. Nor would term life be used in a 1035 Exchange since it has no cash value. The key is that the exchange may not be from a less tax-advantaged contract to a more tax-advantaged contract. *"Same to same"* is acceptable.

Know This! A 1035 exchange is a nontaxable exchange of cash value life insurance or an annuity on the same life.

B. Taxation Of Annuities

1. Individually-owned

A portion of each annuity benefit payment is taxable, and a portion is not. The portion that is nontaxable is the anticipated return of the principal paid in. This is known as the *cost base*. The portion that is taxable is the interest earned on the principal. This is known as the *tax base.*

Accumulation Phase

The accumulation phase is the period after an annuity has been purchased but before distributions begin.

Tax-deferred Accumulation

The cost base represents the premium dollars that have already been taxed and will not be taxed again when withdrawn from the contract. The interest accumulated in an annuity is the tax base, but the **taxes are deferred during the accumulation period.**

Withdrawal of Interest and Principal

When money is withdrawn from the annuity *during the accumulation phase*, the amounts are taxed on a Last In, First Out basis (LIFO). Therefore, all withdrawals will be taxable until the owner's cost basis is reached. After all of the interest is received and taxed, the principal will be received with no additional tax consequences.

One-sum Cash Surrenders

Cash surrender of an annuity results in immediate taxation of the interest earned.

Premature Distributions and Penalty Tax

The IRS imposes a penalty for certain premature distributions under annuity contracts. In addition to ordinary income tax that may be due, a 10% penalty is imposed on the annuity tax base for early withdrawals prior to age 59½.

Example:

Suppose a 58-year-old insured makes an early withdrawal from his annuity. If this withdrawal totals $6,000, and the entire amount is taxable, the insured can expect to receive a penalty equal to 10% of the withdrawal, or $600.

Annuity Phase and the Exclusion Ratio

The **exclusion ratio** is used to determine the annuity amounts to be excluded from taxes. The annuitant is able to recover the cost basis nontaxable. The cost basis is the principal amount, or the amount that was paid into the annuity, which is excluded from taxes. The rest of each annuity payment is interest that has been earned and is taxable.

Taxation of Individual Retirement Annuities (IRAs)

When an annuity is used to fund a traditional IRA, distributions are fully taxable if contributions were made with pretax dollars. If there are no distributions at the required age, or if the distributions are not large enough, the penalty is **50%** of the shortfall from the required annual amount.

Distributions at Death

If the annuity contract holder dies before the annuitization date, the interest accumulated in the annuity becomes taxable. If the beneficiary of the annuity is a spouse, however, the tax can continue to be deferred.

Any unpaid annuity benefits following the death of an annuitant are paid to the beneficiary and are taxable.

Values Included in Annuitant's Estate

If the annuitant died during the **accumulation period**, the insurer is obligated to return all or a portion of the annuity cash value (values accumulated in the annuity in accordance with contract terms), which will be included in the deceased annuitant's estate. If the annuity has been paid up, and the annuitant dies during the **annuity period**, the annuity benefits will be taxable and will be included in the deceased annuitant's estate.

2. Corporate-owned

Corporate-owned annuities have different tax implications than individual annuities:

- Growth in the annuity is **not** tax deferred; and
- Interest income is **taxed** annually unless the corporation owns a group annuity for its employees, and each employee receives a certificate of participation.

TAX CONSIDERATIONS FOR LIFE INSURANCE AND ANNUITIES

Premiums	**Not deductible (personal expense)**
Death Benefit	**Not income taxable (except for interest)**
Cash Value Increases	**Not taxable (as long as policy in force)**
Cash Value Gains	**Taxed at surrender**
Dividends	**Not taxable (return of unused premium; however, interest is taxable)**
Accumulations	**Interest taxable**
Policy Loans	**Not income taxable**
Surrenders	**Surrender value - past premium = amount taxable**
Partial Surrenders	**First In, First Out (FIFO)***

Settlement Options - death benefit spread evenly over income period (averaged). Interest payments in excess of death benefit portion are taxable.

Estate Tax - If the insured owns the policy, it will be included for estate tax purposes. If the policy is given away (possibly to a trust) and the insured dies within 3 years of the gift, the death benefit will be included in the estate.

**FIFO method applies to Life insurance only. The policyowner will receive their investment in the contract first before receiving any gains in the policy (or being taxed on those gains). Annuities follow a LIFO (last in, first out) format.*

C. Business Life Insurance

1. Split Dollar

A **split-dollar** plan is an arrangement where the employer and employee agree to purchase and fund life insurance on an employee. In the most common form, the employer pays the part of the premiums that equals the annual increase in the cash value of the policy, while the employee pays the balance. Should the employee die, the employer recovers the total of its payments from the policy proceeds, with the balance being paid to the employee's beneficiary.

2. Deferred Compensation

Deferred compensation funding refers to any employer retirement, savings, or other deferred compensation plan that is not a qualified retirement plan. Funding involves a contractual commitment between the employer and employee to pay compensation in future years. Usually, funding is made with cash deposits to a life insurance and/or annuity contract.

Deferred compensation funding falls into two major classes:

1. **In-addition funding plans —** designed to pay an amount in addition to the employee's qualified retirement plan; and
2. **Elective plans —** permit the employee to defer part of their salary or bonus as a tax-deferred savings.

These plans are typically made with selected employees to provide additional retirement benefits.

D. Modified Endowment Contract

<u>Educational Objective:</u>

II.F.2. Be able to identify the Internal Revenue Code (IRC) definition of modified endowment contract, including what effect this might have on a policyholder*.*

Generally speaking, an **endowment** policy is an investment instrument. Endowment life insurance policies promise to pay the face amount if the insured survives until the end of a specified period (e.g., 20 years; 30 years; or until the insured's age 65), and if the insured dies within the same specified period. Endowments require premiums far in excess of the amount required to fund the death benefit.

Following the elimination of many traditional tax shelters by the Tax Reform Act of 1984, single premium life insurance remained as one of the few financial products offering significant tax advantages. Consequently, many of these types of policies were purchased solely for the purpose of setting aside large sums of money for the tax-deferred growth as well as tax-free cash flow available via policy loans and partial surrenders.

To curtail this activity, and to determine if an insurance policy is overfunded, the Internal Revenue Service (IRS) established what is known as the **7-pay Test**. Any life insurance policy that fails a 7-pay test is classified as a **Modified Endowment Contract (MEC)**, and loses the standard tax benefits of a life insurance contract. In a MEC, the cumulative premiums paid during the first 7 years of the policy exceed the total amount of net level premiums that would be required to pay the policy up using guaranteed mortality costs and interest.

Once a policy fails the 7-pay test and becomes a MEC, it remains a MEC.

Know This! A MEC is an overfunded life insurance policy = failed the 7-pay test.

Know This! Once a MEC, always a MEC!

All life insurance policies are subject to the 7-pay test, and any time there is a material change to a policy (such as an increase in the death benefit), a new 7-pay test is required. Whether from a life insurance policy or a MEC, the death benefit received by the beneficiary is tax free.

As defined by Section 7702A of the IRS Code, a Modified Endowment Contract is a contract that meets the requirements of a life insurance contract, but fails to meet the 7-pay test, or that is received in exchange for a MEC.

The following are taxation rules that apply to MEC's cash value:

- Tax-deferred accumulations;
- Any distributions are taxable, including withdrawals and policy loans;
- Distributions are taxed on LIFO basis (Last In, First Out) — known as "interest-first" rule; and
- Distributions before age 59 ½ are subject to a 10% penalty.

E. Chapter Recap

This chapter explained the basic taxation principles for life insurance and annuities. Let's recap the taxable, tax-deductible and tax-free features and transactions:

TAXATION	
Life Insurance	• *Premiums* - not tax deductible • *Cash value* - taxable only if the amount exceeds premiums (taxed on gain) • *Policy loans* - not taxable, interest not tax deductible • *Dividends* - not taxable as return of premium; any interest is taxable • *Accelerated benefits* - tax free • *Death benefit* - not taxable if lump-sum; any interest is taxable

	• *Surrenders* - taxable if the cash surrender value exceeds the amount of the premium paid
Annuities	• *Accumulation* - tax deferred in individual annuities, not tax deferred in corporate owned • *Withdrawal of principal and interest* - Last In, First Out basis • *Lump-sum cash surrenders* - taxable • *Premature distribution* - tax and 10% penalty • *Distributions at death* - interest taxable
OTHER RELATED CONCEPTS	
Modified Endowment Contract (MEC)	• Overfunded life insurance policy (7-pay test) • Accumulation - tax deferred • Distributions - taxable Last In, First Out • Distributions before age 59 ½ - 10% penalty
1035 Exchange	Nontaxable if on the same life and one of the following exchanges: • Cash value policy to another cash value policy, endowment or annuity • Endowment to another endowment or annuity • Annuity to another annuity