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ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

A Dozen Income Tax Gotchas In Life Insurance Planning

Michael W. Lagos, CFP®
President

Jane M. Roberts
Director of Client Services

Justin P. Boren , PHD
Chief Compliance Officer

Samuel Escobar
Financial Advisor

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Life insurance is an awesome financial tool. It delivers a pile of money to those who need it when the insured dies.

In recognition of the product's usefulness, the federal government has bestowed many income tax incentives on life insurance that encourage people to buy coverage.

- Income tax-free death benefit
- Tax-deferred cash-value buildup
- Tax-advantaged access to cash during lifetime
- Tax-advantaged ability to access the death benefit early in certain circumstances

Where Congress and the President giveth, sometimes the feds also taketh away. Many life insurance tax advantages are conditional, meaning they can be lost if the taxpayer engages in (or fails to engage in) certain conduct.

Some of the life insurance income tax traps are better known than others. While we have not included every income tax gotcha in our list, we included a dozen of the ones we hear about most.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

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A Dozen Income Tax Gotchas In Life Insurance Planning

A DOZEN GOTCHAS

While the list that follows is not comprehensive, policy owners and life insurance professionals run across these income tax traps commonly.

- Transfer for Value
- Section 101(j)
- Lapse with Loan
- Transfer from Business to Insured
- Split-Dollar Rollout
- Part Sale/Part Gift
- MEC Face Reduction
- MEC Loan Interest
- MEC Security Interest
- Section 1035 Exchange and Taxable Boot
- Force-Outs
- The *Golden* Problem

Transfer for Value

The death benefit of a life policy is generally income tax-free. Section 101(a) of the Revenue Code creates an exception to that rule:

> In the case of a **transfer for a valuable consideration**, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. (Emphasis added.)

Transfers to certain recipients are not subject to the transfer for value rule. The Tax Code specifically says that transfers to the insured, a partnership that includes the insured, a partner of the insured or a corporation in which the insured is an officer or shareholder will not endanger the tax-free nature of the death benefit.

What constitutes a transfer for value? It seems clear that if a policyowner sells an insurance contract to someone else, the transaction would be a transfer for value. However, there are more subtle ways a transferor and transferee can violate the rule.

For example, assume Tom and Dick are the equal owners of a corporation and they have a cross-purchase buy-sell agreement in place. Tom owns insurance on Dick's life and vice versa. Now assume that Harry buys an ownership interest in the company. As part of an update to the buy-sell arrangement, Tom and Dick transfer part of the coverage they own on each other to Harry. The change in ownership would almost certainly be a transfer for value, making Harry's future collection of death proceeds income taxable. The transfer by the existing owners would be made in reliance on Harry's promise that he will participate in the buy-sell arrangement.

Life insurance professionals should examine any proposed change in ownership of a life contract to any party other than the insured for potential transfer for value problems.

Section 101(j)

As part of the Pension Protection Act of 2006, Congress and the President added Revenue Code Section 101(j). That provision makes the death benefit of employer-owned life insurance income taxable.

Fortunately, there is still a method to preserve the tax-free nature of the death proceeds in many business-owned life insurance cases if

- The insured is an employee at any time during the 12-month period before the insured's death or is a director, a highly compensated employee, or highly compensated individual at the time the contract is issued, or
- The death benefits are paid to (or used to purchase an equity interest in the applicable policyholder from) a family member, trust, or estate of the insured employee. See IRS Notice 2009-48.

For situations where preservation of the tax-free death benefit is possible, the law also requires the employer to satisfy the "notice and consent" requirements of Section 101(j)(4) to keep the tax-free death benefit. Notice and consent requires the insured employee to acknowledge, in writing and prior to policy issue, that the employer is seeking a certain amount of coverage on the employee's life.

Failure to satisfy the notice and consent requirement means that any death benefit payable to the employer will potentially be income taxable to the extent it exceeds basis.

Many insurance companies require collecting a signed notice and consent form from the insured prior to issuing a business-owned life policy. However, some do not. Therefore, life insurance professionals need to be aware of the issuing company's practices in this regard and need to be prepared to step in with their own forms to protect against the possibility of a Section 101(j) problem.

Lapse with Loan

One of the key characteristics of permanent life insurance promoted by the "banking on yourself" advocates is that the cash value of non-MEC (modified endowment contract) policies can be accessed in a tax-advantaged way. The usual method is to plan to take tax-free partial surrenders up to an amount equal to the basis in the contract and then to take policy loans thereafter.

Code Section 72(e)(5) says that life insurance policies loans from a non-MEC contact are not taxable distributions at all—as long as the policy stays in force.

What if the loan causes the policy to lapse? That can create an income tax problem for the policyowner.

The Tax Court has confirmed the mess created by a leveraged policy lapse. Most recently, it decided the case of *Doggart v. Commissioner*, T.C. Summ.Op. 2023-25. Under the facts:

> (P)etitioner took out a series of loans against two life insurance policies that he held with Prudential Insurance Co. of America (Prudential). The cash value of his policies served as collateral for the loans. While incarcerated, petitioner stopped paying premiums on the two policies. As a result, each policy lapsed and Prudential used the cash values of the policies to repay the loans plus interest due. Prudential subsequently issued petitioner Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., for 2017 with respect to each policy and reported taxable distributions from life insurance to the Internal Revenue Service (IRS). . . . The amounts reported as taxable on the Forms 1099-R were . . . calculated with respect to each policy as the outstanding loan amount repaid by the cash value of the policy less the total premiums petitioner paid with respect to the policy.

The Tax Court ruled that Prudential's Form 1099-R treatment of the lapse was accurate.

Life insurance professionals who work with clients who have purchased permanent life policies in the past should help make sure the contracts are working as intended and to help avoid an unintentional lapse.

Transfer from Business to Insured

Some life insurance agents get confused about the tax treatment of the transfer of a life policy between employer and insured employee. There are definite income tax consequences of such a change in ownership.

Where a transfer is between the business and a nonowner employee, the transaction will be taxed to the employee (and deducted by the business) as compensation.

Treasury Regulations Section 1.83-3 covers this.

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section. https://www.law.cornell.edu/cfr/text/26/1.83-3#b

Where the transfer is to an owner-employee, the value of the transfer may be treated as a dividend-style distribution rather than as compensation. The actual tax result will depend on

- The tax-nature of the business (e.g., partnership or corporation) and
- Decisions made by the client and the client's tax professionals.

Life insurance professionals should work carefully with the client and client's CPA to determine the most efficient way to transform a business-owned life policy to a personal one.

Split-Dollar Rollout

Under a business split-dollar plan, the employer and employee enter into an agreement regarding how the premium and policy benefits will be split. One simple method of splitting involves having the employer own all the policy's cash value and having the employee control the policy's death benefit in excess of the cash value. This configuration is sometimes called *economic benefit* split dollar.

Under the *loan regime* split dollar, on the other hand, the employer's premium payments are treated as loans to the executive. If the employee pays the employer interest on the loans at or above the applicable federal rate (AFR), the employee pays no additional income tax with regard to the annual value of the plan.

One of the problematic issues with split dollar in either configuration is how to deal with the policy after the employment relationship ends. In many cases the employer and employee will negotiate a rollout, which involves the employer releasing its interest against the life insurance policy and permitting the insured to continue ownership unencumbered.

The tax problem is this: when the employer releases its interest against the policy in favor of the insured, it is—in effect—making an income-taxable transfer to the employee. The income tax result is similar to that described in the immediately preceding section of this newsletter *Transfer from Business to Insured*.

When life insurance professionals help their clients implement split-dollar plans, the parties should include a strategy to manage the tax result at rollout.

Part Sale/Part Gift

When a person makes a gift of a life insurance policy to another family member, typically

- The transferor's basis in the policy carries over to the new owner,
- Neither transferor nor transferee recognizes an immediate income tax result, and
- The transferor must deal with any gift-tax consequences of the transfer.

There is an important exception to the general rule when

- The transferor has a loan balance against the policy, and
- The loan balance is larger than the transferor's basis in the contract.

Under those circumstances, there are two adverse income tax results:

- The transferor will be considered to have surrendered the policy for an amount equal to the loan balance, and
- The transaction will be treated as part sale/part gift, meaning that it's subject to the transfer for value rule. If the transferee is not exempt from the rule's scope, the ownership change will make the death proceeds income taxable.

When a life insurance professional is helping a client change the ownership of an existing policy, the details of the contract should be evaluation for application of the part sale/part gift rule.

MEC Face Reduction

As we discussed earlier, lifetime distributions from non-MEC permanent life insurance contracts are tax advantaged. MECs, on the other hand, are treated differently.

- Loans are potentially taxable distributions for MECs, and
- Withdrawals and dividends are first a taxable distribution of gain.

Also, Code Section 72(v) is explicit that the 10 percent pre-59 ½ extra tax applies to the taxable portion of MEC distributions unless the death, disability, or substantially equal distributions based on life expectancy exception applies.

Usually, MEC testing occurs during the first seven years of the policy's existence. If premium in excess of the seven-pay limit is paid into the policy at that time, the policy becomes a MEC.

If the policy's death benefits (or other benefits) are reduced at any time during the policy's first seven years, the seven-pay limit must be recalculated as if the reduced benefits were in effect from the contract's inception.

The premiums paid in previous years would be compared to the seven-pay limit as if the lower death benefit were in effect from the beginning. If the prior premium exceeded the new limit associated with the lower benefit amount, the contract would be considered a MEC beginning at the time the prior premium exceeded the new, lower limit.

Life insurance professionals who work with clients who have purchased permanent life policies in the past should keep in touch with a client to help make sure the policyowner is not performing a face reduction in the first seven years that would unintentionally trigger MEC status.

MEC Loan Interest

The special MEC tax treatment of policy loans generates questions from clients. For instance, some wonder whether it is better to take loans or withdrawals from MEC contracts.

Here's an example that underscores the difference between the two. Assume Marvin owns a universal life insurance policy that is classified as a MEC. He has paid $100,000 in premiums, and the policy's current cash value is $125,000.

1. If Marvin takes a partial withdrawal of $25,000, the entire distribution will be taxable based on the gain-first distribution rule. If Marvin is younger than 59 ½, he will also be subject to the extra 10 percent tax on the early distribution. That is his only tax result unless and until he takes another distribution.
2. If, on the other hand, Marvin takes a $25,000 loan against the contract, he will also pay income tax (and potentially the 10 percent extra tax) on the distribution. However, if he lets the loan interest accrue against the policy, the annual interest accrual is likely to be another taxable distribution against the policy in the next year. The policy will have gained interest on its cash value during the year, making the cash value (and the amount of gain) bigger. The increasing loan amount will eat up some or all of that gain, causing the additional taxable event.

Because of the possibility of an ongoing income tax liability connected to policy borrowing, we strongly recommend that policyowners think twice before they take loans against MECs.

MEC Security Interest

Since loans are treated as taxable distributions from MEC, it is inadvisable from a tax perspective to allow MECs to be subject to a collateral assignment. Such an assignment is thought to be legally equivalent to borrowing against the contract and thus will subject the policyowner to taxes on the gain in the contract.

Policyowners routinely use collateral assignments against their contracts in connection with transactions such as borrowing. In general, use of collateral assignments against MEC policies should be avoided for the same reason that loans should be avoided.

Force-Outs

Most flexible life insurance premium plans, such as universal life, apply a combination of guideline premium test plus cash value corridor test described more fully in Code Section 7702. Flexible premium life plans must satisfy the tests in Section 7702 in order to qualify for the tax advantages given under U.S. tax law to life insurance policies.

Sometimes when a policy's face amount is reduced—especially in the first 15 years the contract is in force—the reduction can create a situation where prior premiums have exceeded the federal guideline limits. In general, the violation can be fixed with a return of the excess amount to the policyowner—sometimes referred to as a force-out. Unlike other distributions from non-MEC policies, a force-out is taxed on a gain-first basis.

In the real world only an actuary or a computer can calculate guideline premiums for a particular policy. Life insurance professionals should take care when designing a case to avoid the possibility of a force-out in the future. Likewise, when a client is planning for a significant face amount reduction on an in-force policy, the advisor should seek an in-force illustration to check for force-outs or other unexpected consequences of the change.

The Golden Problem

In general, if the insured owns a life insurance contract, the insured can name anyone she wants to be the beneficiary of the contract, while still keeping the death proceeds income tax-free.

If a third party owns the contract, the third party must name itself the beneficiary of the policy. If there's a mismatch in a business situation, it creates income tax trouble.

For example, assume that Ben's company owns a life insurance contract on Ben's life. The company names Ben's wife the beneficiary of the policy's death benefit. At Ben's death, the death proceeds will be treated as a taxable distribution to Ben's wife. See *Golden v. Comm.*, 113 F.2d 590 (3rd Cir. 1940) and Revenue Ruling 61-134.

In a personal situation, assume Cathy owns a life policy on her husband Paul's life. Cathy decides that in the event of Paul's death, she doesn't need the death proceeds. Cathy names their son Brandon as the beneficiary.

At Paul's death, Cathy will be considered to be making a taxable gift to Brandon. While that doesn't expose the death proceeds to income taxes, it does make them subject to gift taxes. See *Goodman v. Comm.*, 156 F.2d 218 (2d Cir. 1946).

The rule of thumb for the professional advisor is that if a third party owns a life contract, the same third party should be the beneficiary.

Section 1035 Exchange and Taxable Boot

This issue often arises where a client owns a permanent life policy with a loan against it. The client wants to exchange the policy for a new, loan-free policy. If allowed, the exchange would essentially permit the taxpayer to get a fresh start with a life policy without it risking a lapse due to a large indebtedness.

Section 1035 of the Internal Revenue Code allows a taxpayer to exchange life policies for new ones without paying tax on the gain.

However, there are policy transfers which may not qualify as tax-free exchanges. One such transfer is the exchange of a life policy with an outstanding loan. Money or other property received as part of an exchange is known as "boot."

If a policy, in which the owner has a gain, is exchanged for a new one and the loan on the old policy disappears as part of the transaction, the owner must recognize taxable boot. The boot is the lesser of the loan repaid or the gain in the policy.

In several private letter rulings, the IRS has held a policy may be exchanged tax-free for another policy, if the new policy is subject to the same amount of indebtedness as the old one.

If the new insurance company will not issue a policy with a loan against it, the taxpayer has two options:

1. Pay off the loan on the old policy with funds from another source and then borrow on the new policy, if necessary.
2. Exchange the policy, "bite the bullet," and pay the tax generated when the loan on the old policy is extinguished.

The IRS may find taxable boot in a step transaction. In Private Letter Ruling 9141025, a taxpayer owned a life insurance policy bought with a single premium of $1 million; there was a $448,000 outstanding loan on the policy. The taxpayer proposed to pay off the loan through a partial surrender (withdrawal) from the policy.

The taxpayer expected to treat the withdrawal as a tax-free return of premium. The plan was to then exchange the remaining cash value for a new policy and treat it as a 1035 exchange.

The IRS thought otherwise. It held the proposed transaction would cause taxable boot equal to the extinguished $448,000 loan; the policy withdrawal would not be an independent transaction but part of a step transaction.

How long must a withdrawal to pay off a policy loan be taken prior to a Section 1035 exchange? No one knows for sure. Life insurance professionals need to make their clients who are considering exchanges aware of the potential problem so that optimal decisions can be made.

CONCLUSION

While life insurance has many powerful income tax features that enhance its attractiveness to prospective buyers, some of those characteristics may be lost in unexpected ways. Financial professionals need to stay vigilant not only so they keep up with the rules but also so they are aware of how their clients are trying to use life contracts.

Many of the items on the income tax gotcha list arise after the contract has been issued. Where agents want to best serve their clients, there is a strong incentive to stay in touch and help with administrative matters while the contract stays in force.

Life insurance policies and the income tax rules can be overwhelmingly complicated for our clients. Let's do our best to make sure our own understanding of the relevant facts is complete.

1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765
Phone: 866-444-4964, Fax: 714-940-0889

IN THIS ISSUE OF ADVISOR'S BULLETIN

Building Protecting and Perpetuating Family Wealth

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