Life Insurance Planning: Common Issues to Watch Out For

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Life insurance is a powerful tool that can accomplish many important financial objectives. Through careful and thoughtful planning, life insurance can be used to effectuate a tax-free transfer of assets from one generation to the next, provide a tax-free benefit to employees, or indemnify a business from loss. However, if improperly managed, the policy proceeds may be inadvertently subject to estate, gift, or income tax.

The tax code is full of traps and pitfalls that are unique to life insurance and may be disastrous to the clients of an uninformed advisor. Understanding the constantly evolving landscape of life insurance products and tax laws, as well as how to avoid common issues that arise from planning mistakes, will allow advisors to maximize their value to clients.

Improper Policy Ownership & Beneficiary Arrangements

One of the most common mistakes occurs in the most fundamental part of any life insurance arrangement: who will own the policy and to whom will benefits be paid.

Inclusion in Taxable Estate

For smaller estates, the simplest arrangement can be for the insured to own the policy, naming the insured's estate as beneficiary. Unfortunately, this structure results in the life insurance proceeds being included in the taxable estate of the insured, with proceeds needlessly exposed to the claims of creditors of the estate. In addition, policy proceeds will be subject to the probate process which can be both expensive and time consuming.

This situation may also occur when the policy owner has named an individual as beneficiary without naming a contingent beneficiary. In the event the beneficiary predeceases the policy owner, policy death benefits may also be paid to the insured's estate. This problem can be easily avoided by naming contingent beneficiaries on the policy application.

Forfeiture of Ownership

In order to avoid inclusion of the policy proceeds in the taxable estate, clients may choose to have the policy owned by their adult children. While this arrangement does accomplish the objective of removing the policy from the estate, potential negative consequences exist, including:

- A loss of control over the policy, including the ability to name the policy beneficiary. In order to avoid inclusion of the policy in the estate of the parent, the parent cannot maintain any incidents of ownership in the policy (effectively, any significant ownership power).
- A lack of creditor protection for the children, potentially exposing policy cash values that are in the policy to the claims of the children's creditors.
- A tax impact on the insured parent who opts to pay future insurance policy premiums. Such payments are considered gifts, resulting in potential gift taxation. In addition, premiums paid directly to the insurance company may not qualify for the annual exclusion.

A variation on this approach involves naming a spouse as owner and a child as a beneficiary. This is a common mistake with the potential for adverse tax consequences. When the owner, insured, and beneficiary are all different parties, the death benefit proceeds in the policy may be considered a taxable transfer from the owner to the beneficiary. For this reason, it is important that if the insured is not the owner, the owner and beneficiary are the same.

Irrevocable Life Insurance Trust

A common method of keeping life insurance proceeds out of an estate, while ensuring that the estate has the necessary amount of liquidity, is to create an irrevocable life insurance trust (ILIT). An ILIT can remove assets from the grantor's and surviving spouse's estates, and can also make the insurance proceeds available to meet the needs of both the surviving spouse and the decedent's estate (e.g., the trust can purchase illiquid assets from the estate to provide liquidity). It is generally best for the trust document to allow the trustee to apply for, own, and be the beneficiary of the insurance policy.

As an alternative to having a trust purchase the policy, the insured may choose to transfer an existing policy to a trust. Unless done carefully, such a transfer can have adverse tax consequences:

- A gift of a policy or funds to an irrevocable life insurance trust is a taxable event.
- A policy gifted to a trust within three years of death will be included in the taxable estate of the decedent.

Transfer-for-Value

A mistake to avoid in life insurance planning is the inadvertent violation of the "transfer-for value" rule. This problem occurs when an interest in a life insurance policy is transferred to

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another party in exchange for "valuable consideration." In most circumstances, life insurance death benefits are payable free of income tax. However, if the transfer-for-value rule is violated, the death benefit proceeds are taxable.

Transfer is broadly defined to include any transfer of a right to receive all, or part, of a life insurance policy. A transfer of the ownership of a policy does not have to occur for a transfer to take place. For example, a transfer-for-value violation can be triggered by naming someone as the beneficiary in exchange for valuable consideration.

Consideration is also broadly defined. While it is clear that a transfer-for-value violation occurs when an individual transfers the ownership of his or her policy in exchange for cash, money does not need to change hands for the rule to apply. A mutual promise can be enough to cause the transfer-for-value rule to apply. For example, the change of policy ownership or beneficiary designation from a business to a shareholder to fund a cross-purchase buy-sell arrangement will trigger the rule because the promise to buy the stock is deemed to be the consideration.

There are exceptions to the transfer-for-value rule. If a transfer for valuable consideration occurs, the death benefit proceeds will not be subject to income tax if the transfer is made to the following exempt transferees:

- The insured, including a Grantor Trust created by the insured[1]
- A partner of the insured
- A partnership in which the insured is a partner or
- A corporation in which the insured is an officer or shareholder
- A transfer in which the basis of the policy in the hands of the transferee was determinable in part by reference to the basis of the policy in the hands of the transferor

1035 Exchanges

An advantage of owning a permanent life insurance policy is the ability to exchange the policy for a new contract. Section 1035 of the Internal Revenue Code allows such exchanges to occur without requiring the policy owner to recognize any gain that has accumulated, instead allowing the basis and gain to be carried over to the new insurance policy. Advisors need to be aware of limits on non-recognition treatment and a tax trap that exists for a Section 1035 exchange of life insurance policies with outstanding policy loans.

1 Letter Ruling 201235006

Permitted Exchanges

Section 1035 specifically provides that no gain or loss shall be recognized on the exchange of:

(1) A contract of life insurance for a) another contract of life insurance, b) an endowment[2], c) an annuity contract, or d) a qualified long-term care insurance contract

(2) A contract of endowment insurance for a) 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, b) an annuity contract, or c) a qualified long-term care insurance contract

(3) An annuity contract for a) another annuity contract or b) a qualified long-term care insurance contract

(4) A qualified long-term care insurance contract for another qualified long-term care insurance contract

As noted above, a life insurance policy can be exchanged for an annuity or endowment; however, Section 1035 does not permit an annuity or endowment to be exchanged for a life insurance policy. This is because the intent of Section 1035 is to allow for tax-deferral, rather than tax elimination. For example, if an annuity or an endowment is exchanged for a permanent life contract, any gain in the contract at the time of exchange would be currently reportable (if the annuity or endowment were to mature, the proceeds would be taxable). By exchanging an annuity or endowment for income tax free life insurance death benefit proceeds, the owner would avoid tax on the gain simply by holding on to the new policy until death.

Same Insured Requirement

Case law and various Private Letter Rulings from the Internal Revenue Service (IRS) have indicated that in order for Section 1035 to apply, the insured in the new contract must be the same as the insured in the old contract. This requirement prohibits certain exchanges from qualifying:

- A single life contract cannot be exchanged and combined with a new insured for a joint life contract[3]
- Two single life contracts cannot be exchanged for a joint life contract[3]

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2 An Endowment contract is defined as a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.
3 Letter Ruling 9542037

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However, case law has indicated Section 1035 does apply when a joint life policy is exchanged for a single life policy following the death of one of the insureds[4]. Note that while such an exchange may be permissible, the life insurance carriers involved may not always be able to administratively accommodate this type of request.

In addition, exchanging one policy into two or more new policies may or may not qualify for tax-free treatment under Section 1035[5] and, once again, the life insurance carriers involved may not always be able to administratively accommodate this type of request.

1035 Exchanges of Policies with Outstanding Loans

Policy owners must take care when exchanging a policy with an existing policy loan. Exchanges with existing loans may result in an unintended tax consequence. The IRS has successfully argued that the release of any debt in the exchange of a life insurance policy should be considered taxable to the policy owner[6].

Technically, the release of such debt is classified as "boot". The name boot comes from the idea that through the exchange the policy owner would be receiving a new policy as well as relief from policy indebtedness "to boot".

When there is a loan against an existing policy, it may be possible for the insurance carrier to issue a new policy subject to the same amount of debt (i.e., carry over the loan from the old policy to the new).

In some instances, policy owners may wish to pay off the loan either prior to or immediately following the exchange, using either an outside source of funds or, in some cases, a withdrawal from the policy itself. Again, care must be exercised to avoid adverse tax consequences. The IRS has successfully argued that the retirement of the loan in close proximity to the exchange is a step-transaction intended to circumvent the taxation of boot[7]. It is therefore inadvisable to consider retirement of the loan and the 1035 exchange as parts of the same decision.

The rules surrounding loan repayment in and around the time of a policy exchange are complex and each case must be evaluated on a facts and circumstances basis. Insurance carriers may differ in their interpretation of what constitutes a "close-proximity" series of events. As the insurance carrier bears the responsibility of reporting taxable events to the IRS, it is ultimately the carrier (and not the policy owner) that must determine what amount of gain, if any, is reported. Advisors are wise to avoid any transactions that could be construed as close-proximity and related, especially if they occur within the same 12 month period. In addition, surveying the insurance carrier(s) involved as to how the exchange will be reported for tax purposes prior to the exchange may help avoid unintended tax consequences.

4 Letter Ruling 9248013 and Letter Ruling 933040
5 Conway v. Commissioner, 111 TC 350 (1998)
6 Treasury Regulation § 1.1035-1(c); Internal Revenue Code 1031(b) and(c)
7 Letter Ruling 8905004 & Letter Ruling 9141025

Modified Endowment Contracts

Background & History

In the tax reform era of the mid 1980s, Congress focused on what was perceived to be an abuse of the tax-favored aspects of permanent life insurance contracts. Specifically, it was believed that life insurance policies that featured tax-deferred accumulation were no longer being used primarily for life insurance protection and were instead being used as tax-favored investment vehicles.

In response, effective June 20, 1988, life insurance policies that fail to meet the definition of life insurance under Section 7702 of the Internal Revenue Code are reclassified as Modified Endowment Contracts (MECs). Once a contract has been classified as a MEC, it will forever be deemed a MEC, and any contract it is exchanged for will be deemed a MEC.

Classification as a MEC

A contract will be classified as a MEC if, at issue, it fails the "Seven-Pay" test described in Internal Revenue Code Section 7702A. This test effectively compares the amount of premium paid into the life insurance policy to the amount of premium necessary to obtain a specific death benefit.

Material modification

In addition to being subject to MEC testing at policy inception, the seven-pay test will be re-administered upon the occurrence of any event which materially modifies the life insurance contract. Such modifications may include, but are not limited to:

- A reduction or increase in the policy's death benefit
- A conversion of a term policy to a permanent life policy
- An exchange of a permanent life policy for another life policy, whether or not the exchange is tax free under Section 1035

Consequences of a MEC

A MEC is similar to a life insurance contract in all aspects except for the following:

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- Lifetime distributions from MECs are taxable as ordinary income until the distributions exceed the gain in the MEC, (i.e., on a Last In, First Out basis)
- Policy loans and pledges of MECs as collateral for loans are taxed as MEC distributions
- A 10% penalty tax is imposed on the includible amount of the MEC distribution, with limited exceptions (e.g., the MEC owner is disabled or over age 59 ½)

Conclusion

The proper management and administration of life insurance policies is critical to avoiding unwelcome surprises that could derail an advisor/client relationship. It is important for advisors to be familiar with the common errors that occur. When in doubt, it is in the advisor's best interest to consult with an experienced life insurance professional that can provide the insight and experience necessary to produce successful results and help reinforce client relationships.

J.R. Burke is the Founding Principal of Perspective Financial Group LLC, located in Berwyn, Pa. Mr. Burke is a Board Member of the Philadelphia Estate Planning Council.

Member News

Children's Literacy Initiative (CLI) announces **David J. Bloom, JD, CFP, Senior Relationship Manager, Hawthron, PNC Family Wealth**, as its new chair of the board of directors. He looks forward to building on CLI's successes as they continue to partner with educators and the community to ensure that more low-income children are reading on grade-level by third grade.

J.R. Burke, CLU, ChFC, CFP, Principal - Perspective Financial Group LLC, was named to Philadelphia Magazine's 2012 Five Star Wealth Manager List for the second consecutive year. These wealth managers who make this list provide exceptional service and overall satisfaction for their clients. This level of excellence is achieved by fewer than 7 percent of the wealth managers in our area. J.R. was selected as a winner under the category of Financial Planning.

Eileen Dougherty, CTFA, CFP®, AEP®, ChFC® joined **Hawthorn, PNC Family Wealth**, as Senior Vice President and Senior Relationship Manager in the Philadelphia Office. She works closely with other Hawthorn Relationship Managers, Investment Advisors, Wealth Strategists and other advisors to deliver Hawthorn's integrated wealth management experience to a limited number of families and individuals.

PEPC President **Mark R. Eskin** and his business partner **Edward S. Blumenthal** of **Stedmark Partners at Janney Montgomery Scott LLC** were named as two of the "Top 1,000 Financial Advisors in America" (and top 40 in Pennsylvania) by Barron's, in its February 16, 2013 issue.

Glen Reyburn, AEP, Univest, has been awarded the Accredited Estate Planner (AEP®) accreditation. The AEP® accreditation is a graduate level specialization in estate planning that is in addition to professional credentials already recognized within the various disciplines of estate planning. It is awarded by the National Association of Estate Planners & Councils (NAEPC) to recognize estate planning professionals who meet stringent requirements of experience, knowledge, education, professional reputation and character.