Common Tax Traps Involving Life Insurance

Presented by Warren Wealth Associates

Life insurance delivers cash to beneficiaries when it's needed most. Plus, if the policy is properly structured, the beneficiaries receive the death proceeds income tax free. By understanding potential tax traps related to life insurance, you can avoid costly mistakes. A few of the most common pitfalls are outlined here.

Three People on a Policy

If you gift property to another person, the transfer triggers gift taxes based on the taxable value of the gift. When you transfer ownership of an existing policy to someone other than your spouse, the gift is immediate and generally approximates the cash value. There is an important exception, however. When the owner, the insured, and the beneficiary are three different people, the gift occurs when the insured dies, and the death benefit is treated as a taxable gift from the policyowner to the beneficiary. Under what is known as the Goodman Rule, the gift is no longer based on the policy's cash value but, rather, on its death benefit.

The solution is to eliminate one party. To avoid potential gift taxes, the owner and the beneficiary or the owner and the insured should be the same person. If the goal is to benefit a third party, an irrevocable life insurance trust should be the owner and beneficiary of the policy.

Three People on a Policy in a Business Situation

This scenario is similar to the previous trap except that, rather than triggering gift taxes, the death benefit is treated as taxable compensation of the employee (or as a dividend of a shareholder). For corporate-owned policies with personal beneficiaries, the business is deemed to have received the death proceeds and then paid them to the employee or shareholder's family. Thus, the beneficiary owes income taxes on the death benefit as a distribution from the business.

One possible solution is an endorsement split-dollar arrangement. With this kind of plan, the business owns the policy but allows the employee to name a personal beneficiary. While the employee is working, the employer is taxed on the policy's "economic benefit." If the policy is properly structured, the death proceeds should be income tax free. Keep in mind that a notice and consent requirement must be met before an employer-owned life insurance contract is issued.

Alternatively, an executive bonus plan can eliminate the tax-on-death problem. The business pays the premiums for a life insurance policy personally owned by the employee. While the employee is working, the payments are treated as additional taxable compensation.

Exchange of a Policy Encumbered with a Loan

Under Section 1035 of the Internal Revenue Code, you can exchange one life insurance contract for another without triggering income taxes. But when an existing loan is extinguished in the exchange, it may cause unwanted tax consequences. Generally, if the loan will be canceled (discharged) in the course of the exchange, then the amount of the loan is treated as ordinary income up to the amount of the policy's gain. The first-in, first-out rule does not apply when a withdrawal is made from the cash value to pay off a loan during or shortly before a 1035 exchange transaction.

One solution is to arrange for the new life insurance policy to take over the existing loan. Because you're in the same economic position before and after the exchange, no gain should result. But keep in mind that the loan may affect the new policy's performance and possibly shorten or eliminate the guaranteed death benefit. Alternatively, you may wish to pay off the loan with out-of-pocket dollars before the exchange. One word of caution: a normally tax-free withdrawal of basis to pay off the loan shortly before an exchange is treated by the IRS as a step transaction and can trigger taxes.

Gift of a Policy Encumbered with a Loan
Typically, the gift of life insurance creates no income tax recognition for either the donor or the recipient, although gift taxes may be involved. When a policy is subject to a loan, however, the transfer of the policy relieves the original policyowner of the debt. Because the donor is deemed to have received an economic benefit from transferring the loan obligation to the new policyowner, the transfer is treated as if the policy were sold. If the loan exceeds the policyowner's basis, the donor will recognize taxable income.

Lapsing a Policy Encumbered with a Loan
One key benefit of permanent insurance is the right to take out a policy loan without having to qualify financially. An insurance company makes a policy loan from its general fund using the policy cash value as collateral. Repayment of the loan principal or the annual interest is optional, and unpaid interest is added to the loan principal. If the borrower fails to repay the loan before the death of the insured, the money is simply withdrawn from the insurance death benefit before it is distributed to the policy beneficiaries.

It's important to note that life insurance contracts may have an automatic premium loan provision that authorizes the insurance company to lend money to pay the premiums if the policyowner fails to do so. Left unmonitored, an automatic loan provision can result in a lapse of the policy and unexpected taxes.

Taking a Withdrawal in the First 15 Policy Years
Normally, a withdrawal from a policy's cash value is treated as coming first from cost basis and subsequently from the contract's gain, resulting in a one-to-one reduction of the death benefit. There is an important exception, however. A withdrawal from a universal life or variable universal life policy within the first 15 policy years will be treated as coming from gain first, if there is any.

To deal with this risk, some insurance companies allow for up to a 10 percent withdrawal with no reduction in the death benefit. If you wish to take more than 10 percent of the policy's cash value, consider structuring the transaction as a loan. Be sure to weigh the long-term cost of the loan against the potential tax associated with a withdrawal.

Incorrectly Structured Cross-Purchase Policies
If it's not properly structured, life insurance purchased to fund buy-sell plans may have unwanted tax consequences. In a cross-purchase buy-sell arrangement, each business partner owns a policy on the other partners. At the death of a partner, the survivors use the insurance proceeds to buy out the estate of the deceased. Thus, each business partner is both the owner and beneficiary of the policy the survivor has taken out on the other. Any other arrangement can fall into the transfer-for-value trap.

If a policy is transferred for money or something of value, the death benefit is no longer fully income tax free. For example, the mutual obligation to purchase a co-owner's business interest at his death would be considered something of value. The transfer-for-value rule also applies when one partner buys a personal policy on their own life and makes their partner the policy beneficiary.

Exceptions to the rule include:

- A transfer of the policy to the insured
- A transfer of the policy to a partner of the insured or a member of a limited liability company taxed as a partnership
- A transfer of the policy to a partnership in which the insured is a full partner
- A transfer of the policy to a corporation in which the insured is a stockholder, an officer, or both
- A bona fide gift, such as a transfer of the policy to a spouse or trust of the insured

The simplest solution is to purchase new policies to fund the buy-sell arrangement. If that's not possible, the business owners should try to qualify under one of the exceptions above. If the business owners are not already partners in some business entity, they may consider creating or investing in a partnership.

Using Life Insurance Instead of a Trust
To avoid the cost and complexity of a trust, some parents elect to have their adult children jointly own their life insurance policies. In such cases, the parent's payment of the premiums directly to the insurance company will not qualify for the annual gift tax exclusion. Although the parent is making an indirect gift to their children, the gift tax exclusion is only available if each policyowner has an unrestricted right to access the policy's cash value. With joint ownership with right of survivorship, neither child can access the cash value without the consent of the sibling.

Sometimes, a parent may transfer their life insurance policy to one child and ask that all siblings remain as beneficiaries, which is a classic example of the Goodman Rule. At the parent's death, the child who owns the policy will be deemed to give the policy proceeds to their siblings, possibly incurring gift taxes.

If optimizing the annual gift tax exclusion is an important goal, consider a trust to hold the life insurance. Alternatively, you can explore ownership as joint tenants in common. With joint tenants in common registration, each owner has an undivided 50 percent interest in the policy's cash value. Not all insurance companies offer this kind of registration, however.

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