NFP Life

Tax Traps Involving Life Insurance and Annuities

Improper beneficiary and ownership designations can have adverse, and sometimes disastrous, income, estate and/or gift tax consequences to clients.

This article will discuss 12 of the most common "tax traps" involving beneficiary and ownership designations. As a tax, legal and/or insurance professional you have a duty to be knowledgeable about these tax traps so that you can properly advise your clients when assisting them with their financial and estate planning. To help identify circumstances where tax traps may exist, we use common fact patterns to illustrate each one and also discuss potential solutions.[1]

Eight Tax Traps Involving Life Insurance

Tax Trap One: Goodman Triangle

Situation

Parent (unmarried) wants to purchase $1 million of death benefit for the benefit of both her adult children (C1 and C2). She would like to avoid adverse estate tax consequences by having the policy owned outside her estate. Therefore, she would like C1 (the more responsible child) to own the policy insuring her, with both C1 and C2 as the named beneficiaries. She plans to pay the $22,000 annual premium directly to the insurance company.

Problem(s)

There are actually two problems with this fact situation. The more obvious one has to do with the gift tax consequences of her payment of the insurance premium.

- Her premium payment is an indirect gift to C1. Since C1 is the sole owner of the policy, only one annual exclusion ($13,000) is available, meaning that one-half of the premium payment will be a taxable gift. If structured properly, for example if an ILIT with Crummey withdrawal provisions were used, then the annual exclusions for both C1 and C2 could have been used to avoid any of the premium being a taxable gift.

The second problem is the tax trap that is frequently overlooked.

- This fact situation violates the so-called Goodman Triangle because three different people are owner (C1), insured (Parent) and beneficiary (C1 & C2) of the policy. In the case of Goodman v. Commissioner, 156 F.2d 218 (1946), it was held that in such a situation the owner of the policy is deemed to make a gift to the non-owner beneficiary upon the death of the insured. Thus, upon the death of the Parent, C1 will be deemed to have made a gift of one-half the death benefit ($500,000) to C2.

[1] This is a concept summary only. This material is for informational purposes only and is not to be construed as tax or legal advice. Individual situations will vary and clients should consult with their own tax, legal and accounting advisors before implementing any plan. The hypothetical case study results should not be deemed a representation of past or future results. This example does not represent any specific product, nor does it reflect sales charges or other expenses that may be required for some investments. No representation is made as to the accurateness of the analysis.

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Solution(s)
There are several possible solutions with respect to avoiding the consequences of the Goodman Triangle:

- Make C1 sole beneficiary of the policy. Of course, that leads to C2 being treated unfairly and may not be the best solution.
- Make both C1 and C2 owners of the policy (thus the owners and beneficiaries are the same and the Goodman Triangle doesn't exist). However, since the Parent is concerned about making C2 an owner due to responsibility issues, this also may not be the best solution.
- Probably the most feasible solution would be to have an ILIT own the policy.

Tax Trap Two: Premium Gifts to Joint Owners

Situation
Same fact pattern as #1, except that now the Parent has indicated that she is comfortable with C1 and C2 both being owners and beneficiaries of the policy.

Problem(s)
The Goodman Triangle is not an issue this time. The problem has to do with the fact that the Parent is paying the premium directly to the insurance company. This will be an indirect gift to the owners of the policy (C1 & C2). However, since the policy is co-owned (the insurance company will generally presume it to be owned jointly with rights of survivorship) and neither C1 nor C2 can access the policy cash values without the consent of the other, this is a future interest gift. Because a prerequisite for the annual exclusion is that it must be a present interest gift, no annual exclusions are available and the entire $26,000 annual premium constitutes a taxable gift.

Solution(s)

- Have Parent create an ILIT for the benefit of C1 and C2 that has Crummey withdrawal provisions.
- Have Parent gift one-half of the premium directly to both C1 and C2, who in turn pay their share of the premium. The direct gifts to C1 and C2 are present interest gifts and will qualify for the annual exclusion.
- Make C1 and C2 tenants in common. This may be easier said than done. Insurance companies' administrative systems are generally set up to administer co-owned policies as owned jointly with rights of survivorship. However, if a tenants-in-common agreement were drafted and submitted, an insurance company may be willing to accept it and administer the policy pursuant to the terms of the agreement. If C1 and C2 are tenants in common, they each have an undivided one-half interest in the cash value and do not need the consent of the other owner to access their interest, thus making the direct payment of premiums by Parent a present interest gift.

Tax Trap Three: Life Insurance in a Credit Shelter Trust

Situation
Trustee of a credit shelter trust wants to purchase a single premium policy insuring the life of the surviving spouse (age 65). Surviving spouse is the trustee and beneficiary, and has a limited power of appointment over the trust property at her death. Although the surviving spouse currently doesn't need the trust funds to live on, she plans to take distributions from the policy in the future should her needs change.

Problem(s)
There are two potential problems with this fact scenario. The more apparent one has to do with possible inclusion of the death benefit in the spouse's taxable estate.

- Pursuant to I.R.C. Section 2042, life insurance proceeds will be includible in an insured's estate if the insured possesses any incidents of ownership in the policy. In this situation, the spouse has an incident of ownership via being the trustee of the trust (i.e., the trustee's incidents of ownership are attributed to her). The spouse also has an incident of ownership via her limited power of appointment (i.e., she has the power to affect the time or manner of the enjoyment of the death proceeds).

The second potential tax trap is frequently overlooked.

- The single premium policy will almost certainly be a modified endowment contract (MEC).[2] If distributions need to be taken from the policy to later support the spouse, the distributions will be taxable to the extent of gain in the policy. This is fairly obvious to most planners and advisors. Less obvious is the fact that such distributions will also likely be subject to a 10 percent penalty.

Given the age of the spouse at the time of the purchase of the policy, most producers and advisors would conclude that an exception to the 10 percent penalty would be applicable. However, the exceptions to the 10 percent penalty for MECs (age 59 ½, disability, substantially equal payments over life or life expectancy) focus on the taxpayer (see I.R.C. section 72(v)). In this situation the owner/taxpayer (i.e., the trust) is a non-natural person, which doesn't have an age, can't become disabled, and doesn't have a life expectancy. Thus, none of the exceptions to the 10 percent penalty should be applicable.

It should be noted that some advisors believe that to the extent that the policy distributions are distributed by the trust in the same tax year, then the ultimate taxpayer (i.e., the trust beneficiary) should be used for purposes of applying the exceptions. However, since policy distribution is reported on the trust tax return (it does receive a deduction for the distribution to the beneficiary), it is likely that the IRS would consider the trust to be the taxpayer. Unfortunately, the IRS has not yet addressed this issue.

Solution(s)

- Estate inclusion can be avoided by having the spouse resign as trustee prior to the purchase of the policy, which should be fairly easy to accomplish. In addition, although it may be not quite as easy to accomplish depending on the terms of the trust and state law, the spouse's limited power of appointment needs to be eliminated (e.g., released) or modified prior to the purchase of the policy.
- With respect to the potential application of the 10 percent penalty in the event distributions need to be taken from the policy, this problem can be avoided simply by designing the policy as a non-MEC from the outset. This can generally be accomplished by paying in the premiums over a period of three to four years rather than all up front in year one.

Tax Trap Four: Corporate-owned Policy Payable to Personal Beneficiary

Situation

ABC Inc. plans to purchase a life insurance policy insuring the life of Owner. Owner's spouse will be the named beneficiary of the policy.

Problem(s)

The death proceeds may be treated as a taxable dividend or compensation to Owner. The reason is that since the corporation is the owner, it is entitled to the death proceeds. The IRS will likely deem the proceeds to have been paid to the corporation and then constructively transferred to the Owner's spouse.

Solution(s)

- The obvious solution would be to make ABC Inc. the beneficiary of the policy. However, the intent here is likely to utilize corporate dollars to provide the Owner with death benefit protection.
- A more viable solution would be to have either the Owner or his spouse own the policy and treat the premiums as a bonus.
- Yet another solution would be to utilize an endorsement split dollar arrangement.[3] This would result in the Owner only being taxed on the economic benefit cost of the death benefit endorsed by the company to the Owner.

[2] Distributions (withdrawals or policy loans) from life insurance policies treated as Modified Endowment Contracts ("MECs") under Section 7702A of the Internal Revenue Code are subject to less favorable tax treatment than distributions from policies that are not MECs. If the policy is a MEC, distributions will be taxable to the extent there is any gain in the policy. In addition, if the policy owner is under age 59 ½ or is a corporation at the time of the distribution, there is a penalty tax of 10% on the taxable amount. Without regard to whether a policy is a MEC, a gain in the policy is taxable on full surrender of the policy.

[3] Split dollar arrangements are subject to IRS Notice 2002-8 and Proposed Regulations that apply for purposes of federal income, employment and gift taxes.

Tax Trap Five: Exchange of Policies for Buy-sell Purposes

Situation

A and B are co-shareholders in ABC Inc. and have just put in place a cross-purchase buy/sell arrangement. A & B both own individual term life insurance policies on their own lives. Since B is now uninsurable and new insurance cannot be purchased to fund the buy/sell, they intend to transfer their term policies to each other to fund the arrangement. After the policies are transferred, each will pay the annual premium on the policy each owns, insuring the other shareholder.

Problem(s)

Upon the death of either A or B, the policy death benefit received will not be income tax-free. Pursuant to I.R.C. Section 101(a)(2), if a policy is transferred for valuable consideration, then the death benefit is tax-free only to the extent of consideration paid and premiums paid thereafter. In this situation the consideration leading to the application of the transfer for value rules is the mutual exchange of the policies for business purposes.

Solution(s)

- Ordinarily, the easiest solution would be to purchase new policies to fund the buy/sell arrangement. However, B is uninsurable.
- Therefore, A and B should attempt to qualify for an exception to the transfer for value rules so that the policies can be transferred without causing loss of the income tax-free death benefit. If A and B are not already partners in some venture, they can attempt to qualify for the partner exception by creating a partnership or possibly by investing in the same publicly traded partnership.

Tax Trap Six: Gift of a Policy with a Loan

Situation

Parent owns a $1 million policy that she intends to transfer to an ILIT. The policy has a basis of $100,000 and a gross cash value of $210,000. The policy also has a loan of $110,000 (the net cash value is thus $100,000).

Problem(s)

This seemingly innocuous situation has a whole host of income and estate tax problems. The key is to recognize that the transfer constitutes a part gift/part sale. The part sale stems from the fact that the Parent's loan obligation is assumed by the ILIT. As a result, a transfer for value has occurred.

Whether or not there will be a loss of the income tax-free death benefit depends upon the value of the loan in comparison to the value of the transferor's basis. This is because of the following exception to the transfer-for-value rule: "The basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor." Anytime, such as in this fact situation, where the loan ($110,000) exceeds the transferor's basis ($100,000), then this exception will be inapplicable and a transfer-for-value problem exists. This is because the transferee's basis will be the higher of the transferor's basis or the amount of the loan (i.e., the cost basis effectively paid to acquire the policy).

The second problem is that since the Parent's loan obligation has effectively been discharged and the value exceeds the Parent's basis in the policy, the transferor has taxable gain equal to the difference ($10,000). This can best be illustrated by assuming for the moment that the policy had no loan and the ILIT actually paid $110,000 for the policy. Now it is more apparent that the $10,000 the Parent realized over and above her basis would be taxable income.

The third problem is that the three-year rule of I.R.C. Section 2035 would cause the death benefit to be includible in the Parent's estate if she were to die within three years of the date of transfer. The three-year rule does not apply to transfers for full and adequate consideration. However, since this was a part gift, the transfer was for less than full and adequate consideration.

Solution(s)

A solution to the first two problems discussed above would be to pay back enough of the loan prior to the transfer so that the loan would be less than the transferor's basis. Now the basis exception to the transfer-for-value rule would apply. In addition, there would be no taxable gain since the transferor's basis would exceed the value of the assumed loan.

A possible solution that may circumvent all three problems discussed above would be to sell the policy to an intentionally defective grantor trust. The three-year rule wouldn't apply, assuming that the sale price constituted full and adequate consideration. The transfer-for-value rule wouldn't be an issue, since the transfer-to-the-insured exception would apply (the insured and the trust are one and the same for income tax purposes). And no taxable gain should be realized since the insured, for income tax purposes, is essentially selling the policy to herself. Of course, a taxable gift may be involved, as the insured may need to seed the trust with the funds needed to fund the sale.

Tax Trap Seven: Collateral Assignment of an MEC Policy

Situation

Insured creates an ILIT for the purpose of acquiring a life insurance policy on his life. Rather than making a gift to the ILIT, the insured instead loans $100,000 to the ILIT, which the trustee uses to purchase a single premium policy. The trustee gives the insured a collateral interest in the policy to secure the loan.

Problem(s)

This fact situation illustrates an arrangement that falls within the loan regime of the final split-dollar regulations.

- The first potential problem is that, depending upon the terms of the collateral assignment, the policy may be includible in the insured's estate. If the collateral assignment gives the insured any incidents of ownership in the policy, such as the right to access the policy values, then the policy will be includible.

The second problem isn't quite so apparent.

- Since the policy is a single premium policy, it is almost certainly a MEC. Pursuant to I.R.C. Section 72(e)(10) and (e)(4)(A), an assignment of the MEC is treated as a distribution, and is taxable to the extent of gain. There are some that believe that as long as there is no gain at the time of the assignment, then there shouldn't be any tax consequences. However, others believe that as long as the assignment still exists at the time that gains begin to accrue, then such gain becomes taxable at that time. Unfortunately, the IRS has not yet addressed this issue.

Solution(s)

- To avoid any possibility of estate inclusion resulting from the assignment, a restrictive collateral assignment should be used. The insured would only have the right to receive his collateral interest in the event of death or termination of the loan arrangement, and would not possess any incidents of ownership.
- To avoid the potential adverse income tax consequences of assigning an interest in a MEC policy, one solution would be to avoid creating a MEC policy at the outset if the intention is to use the policy as collateral for the loan arrangement. This can generally be accomplished by paying the premiums over a period of three to four years rather than all in one year.
- Another solution would be to use other property as collateral for the loan. Of course, this presumes that the ILIT has other property, which is frequently not the case.

Tax Trap Eight: 1035 Exchange of a Policy With a Loan

Situation

Insured has an old $500,000 whole life policy with Old Life Company that he would like to 1035 exchange for a new universal life policy with New Life Company. The policy has a gross cash value of $150,000 and a policy loan of $50,000 (thus, the net cash value is $100,000). Cumulative premiums (i.e., basis) paid are $75,000, so the policy has $75,000 of gain. The insured intends to transfer just the net cash value to the new policy and not carry over the policy loan.

Problem(s)

If the insured goes through with this exchange, he will incur $50,000 of taxable income. This is because the extinguished loan ($50,000) is considered "boot" as part of the exchange and is taxable to the extent of gain ($75,000) in the policy. The insured is in effect exchanging a policy with a gross cash value of $150,000 for a policy with a gross cash value of $100,000. Instead of receiving $50,000 of cash as part of the exchange, which virtually everyone would clearly identify as boot, the insured is relieved of his obligation to repay the $50,000 policy loan. Many policy owners are unaware of this tax trap until they receive a 1099 from the insurance company, at which point it is too late to correct the problem.

Solution(s)

- Payoff the loan prior to the exchange. This should generally be done using the policy owner's own out-of-pocket funds. It may be possible for the policy owner to take a withdrawal of basis from the policy in order to repay the loan. However, if this is done in close proximity before the exchange (12-18 months?), the IRS may consider it to be a step transaction and attempt to assert that there is taxable boot.
- Transfer the loan as part of the exchange. The IRS has indicated in several private letter rulings (see PLRs 8806058, 8604033, and 8816015) that the exchange of a policy with an outstanding loan for another policy subject to the same indebtedness constitutes a valid 1035 exchange. If the policy owner waits a reasonable amount of time (one year is generally advisable), the policy owner can later eliminate the loan on the new policy by taking a withdrawal of basis and using it to repay the loan.

Four Tax Traps Involving Annuities

Tax Trap Nine: Deferred Annuity Owned by Non-natural Person

Situation

ABC Inc. has some extra cash on hand and wants to invest it in a tax-deferred annuity that the company will own.

Problem(s)

The annuity will not be treated as a tax-deferred annuity. This is because I.R.C. Section 72(u) stipulates that income earned on annuities owned by non-natural persons is treated as ordinary income during the current taxable year. Any type of business entity that owns a "deferred" annuity, whether it is a C or S corporation, partnership, or LLC, is likely going to run into this problem. It should be noted that immediate annuities are exempted. Thus, they continue to be taxed based on an exclusion ratio regardless of the owner.

Solution(s)

The company may wish to consider an alternative investment. If tax deferral is of paramount concern, then life insurance should be considered. Life insurance is the only asset that a corporation can own that will provide tax-deferral. This is a major reason why life insurance is generally used to informally fund non-qualified deferred compensation arrangements.

Tax Trap Ten: Trust Owned Deferred Annuity

Situation

A credit shelter trust has excess assets that are not currently needed to provide for the surviving spouse. She is the sole income beneficiary of the trust, and her children are the remainder beneficiaries. The trustee would like to invest these assets in a tax-deferred annuity. The surviving spouse, age 65, will be the annuitant. The goal is to periodically take distributions from the annuity to provide income to her should the need arise.

Problem(s)

Tax trap #9 discussed the problem of having a non-natural person own a deferred annuity. However, that is not the problem here. This is because I.R.C. Section 72(u) contains an exception where a non-natural person holds an annuity as an agent for a natural person. There are numerous private letter rulings indicating that as long as all the beneficiaries of a trust are natural persons, then this exception applies to trust-owned annuities.

The problem is that the 10 percent penalty may apply in the event that distributions are in fact taken in order to provide for the surviving spouse. The exceptions to the 10 percent penalty as they apply to annuities focus on the taxpayer, which in this case is a non-natural person (see I.R.C. section 72(q)). However, the Code expressly provides that for purposes of the exception for death in the case where the taxpayer is a non-natural person, the annuitant is used.

Some advisors believe that to the extent that the annuity distributions are distributed by the trust in the same tax year, the ultimate taxpayer (i.e., the trust beneficiary) should be used for purposes of applying the exceptions. However, since the annuity distribution is reported on the trust tax return (it does receive a deduction for the distribution to the beneficiary), it is likely that the IRS would consider the trust to be the taxpayer. Unfortunately, the IRS has not yet addressed this issue.

Solution(s)

- Invest some of the assets in an alternative investment to help make it less likely that the annuity would ever need to be accessed during the surviving spouse's lifetime.
- Invest the assets in a non-MEC life insurance policy instead of an annuity. This would provide the desired tax-free deferral and, in addition, would provide a tax-free death benefit and the potential for tax-free distributions in the event that additional income is needed.

Tax Trap 11: Gift of a Deferred Annuity

Situation:
Parent owns a tax-deferred annuity that she desires to gift to her son. Parent has sufficient lifetime exemption to cover the value of the gift and doesn't need the funds to live on.

Problem(s):
Any gain in the annuity will be taxable to Parent at the time of the gift. Pursuant to I.R.C. Section 72(e)(4)(C), gain inside an annuity is taxable to the donor when an annuity is transferred for less than full and adequate consideration. Note that this also applies to gifts of annuities to charities and CRTs, which generally makes an annuity a less than ideal asset to gift to charity, as the income realized may substantially reduce the benefits of the charitable deduction.

Solution(s):

- There is no real solution other than the Parent should consider gifting a different asset that won't generate adverse income tax consequences to her.

Tax Trap 12: Collateral Assignment of a Deferred Annuity

Situation
Property Owner would like to take out a $100,000 loan from a bank for the purpose of building on some unimproved land. As collateral for the loan, Property Owner plans to give the bank a collateral interest in a deferred annuity personally owned by him. The annuity has a basis of $100,000 and a value of $150,000 (thus, there is $50,000 of gain).

Problem(s)
Property Owner will have $50,000 of taxable income. Pursuant to I.R.C. Section 72(e)(4)(A), the collateral assignment of a deferred annuity is treated as a distribution and is taxable to the extent of gain.

Solution(s)

- Consider using other property as collateral for the loan.

Conclusion

Life insurance professionals should request that any clients desiring to make an unusual ownership or beneficiary designation consult their tax advisor before doing so. Tax advisors have a responsibility to thoroughly research the income, gift, and estate tax consequences of unusual ownership or beneficiary designations to ensure that their clients do not suffer any unexpected tax consequences.

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