Common Life Insurance Tax Traps

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Common problems that are frequently overlooked with life insurance

The goals of this program are twofold:

1. Outline in a usable format some of the common errors made in the issuance of life insurance policies; and
2. Provide you with knowledge to assist you with your current client base and in obtaining new clients. (We hate to find them but it can't hurt if you point out to a potential client that his current $1 million dollar life insurance policy could generate up to $850,000 in federal tax!)

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Problem Number 1

Do you have an insurable interest?

Yes, I know this is basic stuff but more and more it is appearing in the cases and rulings.

What are insurable interest laws? See XCEL Energy, Inc. v. United States. They are laws passed by states (thus every state's law will vary) designed to insure that insurance contracts are not "wager contracts" taken by individuals who have no relation to the insured and who may thus "have a direct interest in the insured's early termination."

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Insurable Interests, continued

Please examine carefully each policy that is issued by a trust, a business entity (i.e., Corporation, LLC, Partnership, etc.) to determine that a valid insurable interest exists.

In XCEL, the corporation purchased group whole life insurance contracts on non-key, rank and file employees seeking to deduct the costs of the insurance, borrow from the policies, deduct the interest on the loans and take the death benefits tax free. The court found there was an insurable interest. However, this area is far from clear.

If an insurable interest is found not to exist by the IRS then all of the positive tax benefits of insurance will be denied.

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Insurable Interest, continued

- Beware of any plan that involves the use of trusts, business entities or charities using large up front premiums with considerations of using loans immediately.
- You may hear the names of COLI (company owned life insurance), BOLI (bank owned life insurance), CHOLI (charity owned life insurance), POLI (partnership owned life insurance) and TOLI (trust owned life insurance).
- You must carefully examine any transactions outside of the "run of the mill" policies in these areas.

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Problem Number 2, The Goodman Triangle

Facts: A, the parent, wants to purchase a $1 million dollar life insurance policy on her life but doesn't want to bother with those extra legal costs associated with having an attorney draft an ILIT. So she names her son Bert as the owner of the policy and names Bert and Ernie, her other son, as beneficiaries and promptly begins paying the $30,000 annual premium. Bert is responsible and Ernie is a bum who has three times filed for Bankruptcy, most recently on Oct. 15, 2005 before the new rules came into effect.

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Goodman Triangle, continued.

- The first problem is obvious. She is making a gift of $30,000 per year to Bert.
- The second problem is not so obvious. In Goodman v. Commissioner, it was held under the fact pattern presented here that mom was making a $500,000 gift to Ernie, the non-owner, upon her death.

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Goodman Triangle, continued.

Possible solutions:

1. Make Bert the sole owner and beneficiary. This will work but will make mom unhappy and Ernie will not get money to blow.
2. Make both Bert and Ernie owners. This will work but Ernie will probably lose his interest in bankruptcy and make mom unhappy.
3. Pay the attorney's fees and draft an ILIT!

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Problem Number 3, Life Insurance Inside a Credit Shelter Trust.

The trustee of a credit shelter trust wants to purchase a single premium policy insuring the life of the surviving spouse (age 65) who is also the trustee and beneficiary and has a limited power of appointment at her death.

Trap number 1. The estate tax provisions (2042) will require the inclusion of the death benefit in the spouse's estate because the power of appointment creates an incident of ownership.

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Problem Number 3, Continued.

- Second trap - Will the policy be a MEC and if distributions from the policy are later taken by the spouse, they will not only be taxable, they will be subject to the 10% penalty and there will be no exceptions. Remember the exceptions to the MEC penalty provisions focus on the taxpayer (i.e., Age 59 1/2, disability, etc.) In this instance the owner is a trust. Therefore no exceptions.

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Problem Number 3, continued.

- Solutions

  1. Have the spouse resign as trustee before the policy is purchased.

  2. Design the policy as a non MEC by paying the premiums over three or four years instead of one.

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Problem Number 4, Corporate Owned Policy Payable to Personal Beneficiary.

This is a common problem that is usually overlooked. A corporation purchases a life insurance policy, as owner of the policy, on the life of one of its owners with the owner's spouse named as beneficiary.

Problem – The death proceeds may be treated as a taxable dividend (or tax the payment as compensation) because the corporation is the owner and therefore entitled to the proceeds.

The IRS will treat the death benefit as having been constructively paid to the corporation and then distributed to the named beneficiary.

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Problem number 4, continued.

Solutions:

1. Have either the shareholder or spouse own the policy and treat the premium payments as income.
2. Use endorsement split dollar.

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Problem Number 5, 1035 Exchange of a Policy With A Loan

Insured has an old $500,000 whole life policy with Oldlifeco that he wants to exchange for a new universal life policy with Newlifeco. Oldlifeco's policy has cash value of $150,000 and a loan of $50,000 and premiums paid to date equal $75,000,producing a built-in-gain of $75,000. Only the net $75,000 will be transferred to the new policy.

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Problem Number 5, continued.

- Problem

  The transfer of the policy will produce $50,000 of taxable income because the loan extinguishment is treated as boot and will produce income to the extent of built-in-gain.

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Problem Number 5, continued.

Solutions:

1. Pay off the loan prior to the exchange. If possible use the policy owner's own funds. You may try to withdraw basis from the old policy and use it to repay but if it's too close in time the IRS could collapse the transaction.
2. Transfer the policy with the loan. In PLRs 8806058, 8604033 and 8816015, the IRS ruled that a valid, nontaxable 1035 exchange may be made if one policy with a loan is exchanged for another policy with a loan. You should then generally wait at least a year before withdrawing funds to repay the loan.

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Thank you for attending.

Please fill out the evaluation forms.

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