Understanding Life Insurance Taxation

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Life insurance is the cornerstone of financial protection for millions of families and businesses. It is a useful and valuable product with a number of important potential tax advantages. Studies have shown the tax attributes of life insurance are frequently misunderstood by the general public.

The following are the most commonly asked questions about the taxation of death and living benefits of life insurance.

1. **How are death benefits of a life insurance policy taxed?**
   Life insurance death benefits paid to a named beneficiary are income-tax-free in most circumstances. The only exceptions are; 1) a contract that violates the guideline premium rules (discussed in question #5) or 2) a corporate-owned policy on the life of an employee where the company is the beneficiary, and certain requirements have not been met under Internal Revenue Code (IRC) Section 101(j).

2. **How are living benefits of a life insurance policy taxed?**
   There are several different types of life insurance living benefits to consider.

   - **Cash values:** Cash values inside of an insurance contract accumulate income tax-deferred.
   - **Withdrawals:** Assuming the policy is not a Modified Endowment Contract (MEC) (see question #3), cash values withdrawn from a life insurance policy are first considered a "return of cost basis" (premiums previously paid) until all the cost basis has been recovered. This is referred to as "first-in, first-out" treatment of FIFO. The cost basis is recovered income tax free. Once the cost basis has been recovered, future withdrawals are taxed as ordinary income in the year received as they represent gain in the policy.
   - **Loans:** Assuming again a non-MEC policy, loans are not subject to current taxation. However, outstanding policy loans may become income taxable if/when the policy lapses, is surrendered, exchanged, or otherwise terminated prior to death.
   - **MEC Withdrawals and Loans:** In the case of a policy designated as a MEC, loans and withdrawals are income taxable to the extent of the gain in the policy (gross surrender value minus the cost basis). In addition, and a 10% penalty may apply if these loans or withdrawals are taken prior to age 59½.
   - **Accelerated Death Benefits:** A policy may include a provision that permits the payment of benefits under certain circumstances if an insured is terminally ill. These benefits are considered advanced payments of the death benefit and, therefore, are not income taxable just like death benefits.
   - **Long Term Care Benefits:** A policy may provide for the payment of benefits under a long term care rider. These benefits qualify for income tax free treatment in the same way as benefits from a traditional long term care insurance policy.

3. **What is a Modified Endowment Contract (MEC)?**
   A MEC is a policy in which the cumulative premiums paid exceed the cumulative TAMRA (or 7-pay) premium at any time in the first 7 policy years. The TAMRA or 7-pay rules come from the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) which created IRC Section 7702A. The purpose of

TAMRA was to limit perceived abuses by establishing maximum premium limits (7-pay or MEC rules) to prevent payment of large single premiums and accessing those funds later on a tax free basis.

4. **What happens if a policy becomes a MEC?**
   - Any future loans or withdrawals are income taxable immediately up to the amount of gain* on a last-in, first-out (LIFO) basis like a deferred annuity.
   - An additional 10% penalty tax is applied on any taxable loans or withdrawals made before age 59½.
   - Once a policy becomes a MEC, it remains a MEC for its entire existence.
   - If a MEC is exchanged for a new contract under IRC Section 1035, the MEC status is transferred to the new contract.
   - Death benefits payable from a MEC, retains the benefit under IRC 101(a) of income tax-free death benefit proceeds as well as tax-deferred growth of policy cash values while they remain inside the policy.

   If MEC status is created due to an inadvertent excess payment, the problem can be avoided by a return of the excess premium with interest within 60 days. NOTE: A material change to a policy starts a new 7-year period.

   *The gain in the policy is the amount the cash surrender value exceeds the "cost basis" as reported by the insurance company.

5. **I see the term Guideline Premium Test (GPT) on an illustration. What does this mean?**
   The Guideline Single Premium (GSP) and the Guideline Annual Premium (GAP) are mathematical calculations established to define the maximum premiums paid into a policy to have it qualify for the tax advantages of life insurance. The sum of the premiums paid cannot exceed the greater of the GSP or the cumulative GAP.

   There are two parts to the test. The premiums cannot exceed certain limits, and the death benefit cannot be less than the specified percentage of the cash value. Both of these tests define what is and is not a life insurance policy and were created by two laws which are now part of the Internal Revenue Code. They are:

   - TEFRA (IRC Section 101) - Tax Equity and Fiscal Responsibility Act of 1982
     - TEFRA established guideline premium test (GPT)

   - DEFRA (IRC Section 7702) – Deficit Reduction Act of 1984
   - DEFRA clarified rules governing withdrawals and extended qualification testing to all cash value life policies (CVAT)

6. **I see the term Cash Value Accumulation Test (CVAT) on an illustration. What does this mean?**
   Under the CVAT test, premiums are not expressly limited; however, the policy's cash value cannot exceed the net single premium of future benefits. This test determines the appropriate amount of death benefit and premium for the policy to be considered a life insurance policy and thereby enjoying the tax benefits attributed to these contracts.

7. **What happens if premiums are paid in excess of the limits that cause these tests to fail?**
   While this may vary to some degree, virtually all insurance companies will take similar actions in this event.
   - If all or a portion of the premium exceeds the TEFRA/DEFRA guideline, the excess money is refunded to the policyholder with a letter of explanation so the contract will still qualify as life insurance.
   - If a premium payment causes a policy to become a MEC, a letter of explanation (without a refund) is generally sent to the policyholder. The policyholder will have 60 days to respond if a refund is desired. Otherwise, the money will remain in the policy and the policy will be a MEC from that point forward.

   Remember even if a policy is designated a MEC, it still enjoys the income tax free treatment of death benefits paid to the beneficiary. MEC status only impacts withdrawals or loans from the contract while the insured is still alive.

8. **Why are the guideline premiums different from one policy to another for an insured of the same age and for the same death benefit?**
   The guideline premium calculations are based on the policy's statutory cost of insurance rates, expenses, and guaranteed interest rates. Since different companies will have different assumptions for these items, their calculations will result in different guideline premium amounts.

9. **What happens to the guidelines or TAMRA (MEC) premiums if a policyholder changes the death benefit of an existing policy?**
   If a request is made to change the death benefit of a policy, the GSP and GAP are adjusted to reflect the requested change in benefits. An added twist for MEC premiums is that:

   - For a Death Benefit increase, the MEC period (7 years) starts over again as of the date of the change, and
   - For a Death Benefit decrease, the policy may be retested from inception at the reduced coverage amount to determine MEC status.

   Significant coverage and/or benefit changes could cause a violation when the policy is retested. In this event, some cash value may be "forced out" of the policy resulting in a potential taxable event.