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Study Chapter

Federal Tax Considerations for Life Insurance

This section will help broaden your knowledge of life insurance and annuities by explaining the subject of taxation. You will learn the basic principles of taxation of policy benefits, dividends, and loans, as well as options available for nontaxable exchanges.

TERMS TO KNOW

Earned income — salary, wages, or commissions; but not income from investments, unemployment benefits, and similar
Gross income — a person's income before taxes or other deductions
FIFO (First In, First Out) — principle under which it is assumed that the funds paid into the policy first will be paid out first
LIFO (Last In, First Out) — principle applied to asset management in life insurance products,

under which it is assumed that the funds paid into the policy last will be paid out first
Nonprofit organization — an organization that uses its surplus to fulfill its purpose instead of distributing the surplus to its owners or members
Policy endowment — maturity date
Policy proceeds — in life insurance, the death benefit
Pretax contribution — contribution made before federal and/or state taxes are deducted from earnings
Rollover — withdrawal of the money from one qualified plan and placing it into another plan
Surrender — early termination of a policy by the policyowner
Tax deductible — a reduction of taxable income, resulting in lower tax liability
Taxable — subject to taxation, payable to state and federal government
Tax deferred — taxes on investments or gains (such as interest or dividends) are paid at a future date instead of in the period in which they are incurred tax
Vesting — the right of a participant in a retirement plan to retain part or all of the benefits

A. Qualified Plans Requirement

An employer-sponsored **qualified retirement plan** is approved by the IRS, which then gives both the employer and employee benefits such as deductible contributions and tax-deferred growth.

Qualified plans have the following characteristics:

- Designed for the exclusive benefit of the employees and their beneficiaries;
- Are formally written and communicated to the employees;
- Use a benefit or contribution formula that does not discriminate in favor of the *prohibited group* — officers, stockholders, or highly paid employees;
- Are not geared exclusively to the prohibited group;
- Are permanent;
- Are approved by the IRS; and
- Have a vesting requirement.

Know This! Qualified plans have tax advantages.

In contrast, nonqualified plans are not subject to the requirements regarding participation, discrimination, and vesting as qualified plans. Nonqualified plans require no government approval and are used as a means for an employer to discriminate in favor of a valuable employee with regard to employee benefits. Nonqualified plans accept after-tax contributions.

The table below highlights the differences between qualified and nonqualified retirement plans.

QUALIFIED	NONQUALIFIED
Contributions currently TAX DEDUCTIBLE	Contributions NOT currently TAX DEDUCTIBLE
Plan APPROVED by the IRS	Plan DOES NOT NEED IRS APPROVAL
Plan CANNOT DISCRIMINATE	Plan CAN DISCRIMINATE
Earnings grow TAX DEFERRED	Earnings grow TAX DEFERRED
ALL WITHDRAWALS are TAXED	EXCESS over cost basis is TAXED

B. Types of Qualified Plans

1. Individual Qualified Plans - IRA and Roth IRA

The 2 most common qualified individual retirement plans are Traditional IRAs and Roth IRAs. Anybody with **earned income** can contribute to either plan.

A Traditional **Individual Retirement Account (IRA)** allows individuals with **earned income** to make tax deductible contributions **regardless of age**. Plan participants are allowed to contribute up to a specified dollar limit each year, or 100% of their salary if less than the maximum allowable amount. Individuals who are **age 50 or older** are entitled to make additional *catch-up* contributions. A *married couple* could contribute a specified amount that is double the individual amount, even if only one person had earned income. Each spouse is required to maintain a separate account not exceeding the individual limit.

In traditional IRAs, the owner may **withdraw** the funds at any time. However, withdrawals prior to age 59 ½ are considered early withdrawals and are subject to a 10% additional tax. Starting at age 59 ½, the owner may withdraw assets without having to pay the 10% additional tax. However, the owner *must* start receiving distributions from the IRA at the **age of 73***. Starting at age 73, the owner must receive at least a minimum annual amount, known as the **required minimum distribution (RMD).**

**Effective January 1, 2023, the SECURE Act raised the required minimum distribution age from 72 to 73, and reduced the penalty for failing to take an RMD from 50% to 25%.*

The **Roth IRA** is a form of an individual retirement account funded with after-tax contributions. An individual can contribute 100% of earned income up to an IRS-specified maximum, as with traditional IRAs (the dollar amounts change every year). Roth IRA contributions can continue regardless of the account owner's age, and in contrast with a traditional IRA, distributions do not have to begin at a specified age. Roth IRAs grow tax free as long as the account is open for at least 5 years.

Know This! Traditional IRAs and Roth IRAs are for individuals with earned income.

Know This! Contributions to a traditional IRA are with pre-tax dollars (tax deductible); contributions to a Roth IRA are with after-tax dollars (NOT tax deductible).

In addition to individual plans, different types of qualified plans are available and have been designed for use by small and large employers.

2. Profit Sharing and 401(k) Plans

Profit-sharing plans are qualified plans where a portion of the company's profit is contributed to the plan and shared with employees. If the plan does not provide a definite formula for figuring the profits to be shared, employer contributions must be **systematic and substantial**.

A 401(k) qualified retirement plan allows employees to take a reduction in their current salaries by deferring amounts into a retirement plan. The company can also match the employee's contribution, whether it is dollar for dollar or on a percentage basis.

Under a 401(k) plan, participants may choose to do one of the following:

- Receive *taxable cash compensation;* or
- Have the money contributed into the 401(k), in *cash or deferred arrangement plans* (CODA).

Contributions into the plan are excluded from the individual employee's gross income up to a specified dollar amount. The ceiling amount is adjusted annually for inflation. The plan allows participants age 50 or over to make additional catch-up contributions (up to a limit) at the end of the calendar year.

A 401(k) plan may be arranged as:

1. Pure salary reduction plan;
2. Bonus plan; or
3. Thrift plan.

Under the bonus or thrift plan, the employer will contribute certain amount or percentage for each dollar contributed by the employee; however, employee contributions are not always required.

Plans permit early withdrawal for specified hardship reasons such as death or disability. Loans are also permitted in certain instances up to 50% of the participant's vested accrued benefit or the annual IRS-established dollar amount.

3. 403(b) Tax-sheltered Annuities (TSAs)

A 403(b) plan or a tax-sheltered annuity (TSA) is a qualified plan available to employees of certain **nonprofit organizations** under **Section 501(c)(3)** of the Internal Revenue Code, and to employees of public school systems.

Contributions can be made by the employer or by the employee through salary reduction and are excluded from the employee's current income. As with any other qualified plan, 403(b) limits employee contributions to a maximum amount that changes annually, adjusted for inflation. The same catch-up provisions also apply.

Know This! 403(b) plans are for nonprofits and public-school systems.

C. Taxation of Qualified Plans

If the general requirements for qualified plans are met, the following tax advantages apply:

- Employer contributions are tax deductible to the employer, and are not taxed as income to the employee;
- The earnings in the plan accumulate tax deferred; and
- Lump-sum distributions to employees are eligible for favorable tax treatment.

1. Traditional IRAs

Contributions, Deductible Amounts, and Distributions

The following taxation rules apply to **contributions** made to traditional IRA plans:

- Tax-deductible contributions for the year of the contribution (based on the person's income);
- Contributions must be made in **"cash"** in order to be tax deductible (the term *cash* includes any form of money, such as cash, check, or money order);
- Excess contributions are taxed at 6% per year as long as the excess amounts remain in the IRA; and
- Tax-deferred earnings (the money that accumulates in the account) are not taxed until withdrawn.

A **distribution** from an IRA is subject to income taxation in the year the withdrawal is made. In case of an early distribution (prior to age 59 ½), a 10% penalty will also apply.

There are certain conditions, under which the 10% penalty for early withdrawals would not apply (penalty tax exceptions):

- Participant is age 59½;
- Participant is totally disabled;
- The money is used to make the down payment on a home (not to exceed $10,000, and usually for first-time homebuyers);
- Withdrawals are for post-secondary education expenses; and
- Withdrawals are for catastrophic medical expenses, or upon death.

Amounts Received by Beneficiary

If the owner dies before distributions have begun, the entire interest must be distributed in full on or before December 31 of the calendar year of the 5th anniversary of the owner's death, unless the owner named a beneficiary.

Spouses who are the sole designated beneficiary can do the following:

- Treat an IRA as their own;
- Base the required minimum distribution (RMD) on their own current age;
- Base the required minimum distribution on the decedent's age at death, reducing the distribution period by one each year; or
- Withdraw the entire account balance by the end of the 5th year following the account owner's death, if the account owner died before the required beginning date. If the account owner died before the required beginning date, the surviving spouse can wait until the owner would have turned 73 to begin receiving RMDs.

Individual beneficiaries other than a spouse must withdraw the entire amount from the account within **10 years** of the account owner's death. Non-spouse beneficiaries are not permitted to treat an inherited IRA as if it were their own: they are specifically not allowed to make contributions to the IRA or to roll over any amounts into or out of the inherited IRA.

Like the original owner, the beneficiary generally will not owe tax on the assets in the IRA until they receive distributions from it.

2. Roth IRAs

The following taxation rules apply to Roth IRAs:

- Contributions are not tax deductible; and
- Excess contributions are subject to a 6% tax penalty.

Know This! Traditional IRA distributions are taxable; Roth IRA distributions are NOT taxable.	
TRADITIONAL IRA	**ROTH IRA**
Contribute 100% of income up to an IRS-specified limit	
Excess contribution penalty is 6%	
Grows tax deferred	Grows tax free (if account open for at least 5 years)
Contributions are **tax deductible** (Made with "pre-tax dollars")	Contributions are **not tax deductible** (Made with "after-tax dollars")
10% penalty for early nonqualified distributions prior to age 59 ½ (some exceptions apply) Distributions are **taxable**	Qualified distribution cannot occur until account is open for 5 years and owner is 59½ Distributions are **not taxable**
Payouts must begin by age of 73	No required minimum age for payouts

3. Rollovers and Transfers

Situations exist in which a person may choose to move the monies from one qualified retirement plan to another qualified retirement plan. However, benefits that are withdrawn from any qualified retirement plan are taxable the year in which they are received if the money is not moved properly. There are 2 ways to accomplish this: a **rollover** and a **transfer** from one account to another.

A **rollover** is a tax-free distribution of cash from one retirement plan to another. Generally, IRA rollovers must be completed within 60 days from the time the money is taken out of the first plan. If the distribution from the first plan is paid *directly to the participant*, 20% of the distribution must be withheld by the payor. The 20% withholding of funds can be avoided if the distribution is made *directly from the first plan to the trustee or administrator/custodian of the new IRA plan.* This is known as **direct rollover**.

The term **transfer (or direct transfer)** refers to a tax-free transfer of funds from one retirement program to a traditional IRA or a transfer of interest in a traditional IRA **from one trustee directly to another**.

D. Taxation of Personal Life Insurance

Generally speaking, the following taxation rules apply to life insurance policies:

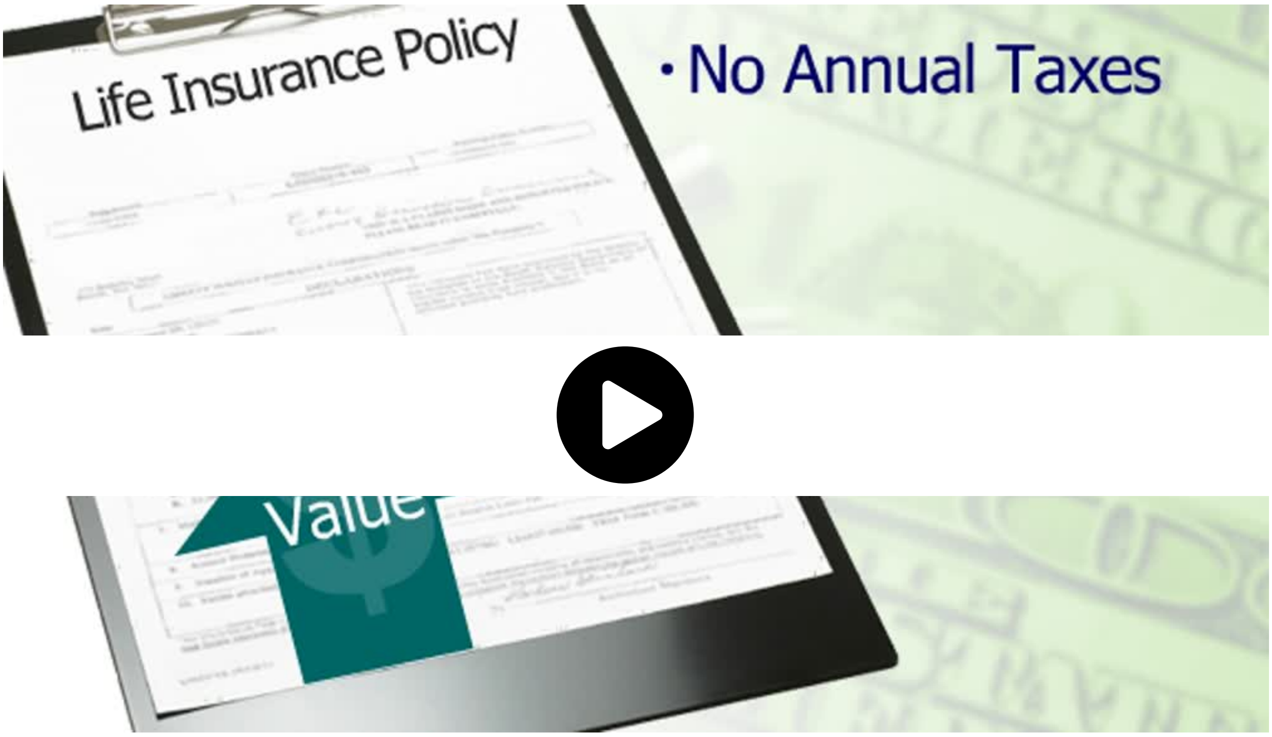
- **Premiums** are not tax deductible; and
- **Death benefit:**
  - Tax free if taken as a lump-sum distribution to a named beneficiary; and
  - Principal is tax free; interest is taxable if paid in installments (other than lump sum).

1. Amounts Available to Policyowner

As you have already learned, permanent life insurance provides living benefits. There are several ways in which policyowners may receive those living benefits from the policy.

Cash Value Increases

Any cash value accumulations in the policy can be borrowed against by the policyowner, or may be paid to the policyowner upon surrender of the policy. Cash values grow tax deferred. Upon surrender or endowment, any cash value in excess of cost basis (premium payments) is taxable as ordinary income. Upon death, the face amount is paid, and there is no more cash value. Death benefits generally are paid to the beneficiary income tax free.



Dividends

Since dividends are a return of unused premiums, they are not considered income for tax purposes. When dividends are left with the insurer to accumulate interest, the interest earned on the dividend account is subject to taxation as ordinary income each year interest is earned, whether or not the interest is paid out to the policyowner.

Accelerated Benefits

When accelerated benefits are paid under a life insurance policy to a terminally ill insured, the benefits are received **tax free**. When accelerated benefits are paid to a chronically ill insured (*for example*, someone who has cancer, Alzheimer's disease or other severe illness), these benefits are tax free up to a certain limit. Any amount received in excess of this dollar limit must be included in the insured's gross income.

2. Amounts Received by Beneficiary

General Rule and Exceptions

Life insurance proceeds paid to a named beneficiary are generally **free of federal income taxation** if taken as a lump sum. An exception to this rule would apply if the benefit payment results from a *transfer for value*, meaning the life insurance policy is sold to another party prior to the insured's death.

Know This! Lump-sum cash payment of life policy proceeds are tax free for the beneficiary.

Settlement Options

With **settlement options**, when the beneficiary receives payments consisting of both principal and interest, the interest portion of the payments received is taxable as income. *For example,* if $100,000 of life insurance proceeds were used in a settlement option paying $13,000 per year for 10 years, $10,000 per year would be income tax free and $3,000 per year would be income taxable.

Know This! In settlement options, the principal is tax free, but the interest is taxable.

PERMANENT LIFE FEATURES	TAX TREATMENT
Premiums	Not tax deductible
Cash value exceeding premiums paid	Taxable at surrender
Policy loans	Not income taxable
Policy dividends	Not taxable
Dividend interest	Taxable in the year earned
Lump-sum death benefit	Not income taxable

Know This! Taxes must be paid either upon contribution or upon distribution, NOT both (if taxed on one end, will not be taxed on the other).

TAX CONSIDERATIONS FOR LIFE INSURANCE AND ANNUITIES	
Premiums	**Not deductible (personal expense)**
Death Benefit	**Not income taxable (except for interest)**
Cash Value Increases	**Not taxable (as long as policy in force)**
Cash Value Gains	**Taxed at surrender**
Dividends	**Not taxable (return of unused premium; however, interest is taxable)**
Accumulations	**Interest taxable**
Policy Loans	**Not income taxable**
Surrenders	**Surrender value - past premium = amount taxable**
Partial Surrenders	**First In, First Out (FIFO)***

Settlement Options - death benefit spread evenly over income period (averaged). Interest payments in excess of death benefit portion are taxable.

Estate Tax - If the insured owns the policy, it will be included for estate tax purposes. If the policy is given away (possibly to a trust) and the insured dies within 3 years of the gift, the death benefit will be included in the estate.

**FIFO method applies to Life insurance only. The policyowner will receive their investment in the contract first before receiving any gains in the policy (or being taxed on those gains). Annuities follow a LIFO (last in, first out) format.*

E. Modified Endowment Contracts (MECs)

Generally speaking, an **endowment** policy is an investment instrument. Endowment life insurance policies promise to pay the face amount if the insured survives until the end of a specified period (e.g., 20 years; 30 years; or until the insured's age 65), and if the insured dies within the same specified period. Endowments require premiums far in excess of the amount required to fund the death benefit.

Following the elimination of many traditional tax shelters by the Tax Reform Act of 1984, single premium life insurance remained as one of the few financial products offering significant tax advantages. Consequently, many of these types of policies were purchased solely for the purpose of setting aside large sums of money for the tax-deferred growth as well as tax-free cash flow available via policy loans and partial surrenders.

1. Seven-pay Test

To curtail this activity, and to determine if an insurance policy is overfunded, the Internal Revenue Service (IRS) established what is known as the **7-pay Test**. Any life insurance policy that fails a 7-pay test is classified as a **Modified Endowment** Contract **(MEC)**, and loses the standard tax benefits of a life insurance contract. In a MEC, the cumulative premiums paid during the first 7 years of the policy exceed the total amount of net level premiums that would be required to pay the policy up using guaranteed mortality costs and interest.

Once a policy fails the 7-pay test and becomes a MEC, it remains a MEC.

Know This! A MEC is an overfunded life insurance policy = failed the 7-pay test.

Know This! Once a MEC, always a MEC!

2. MEC vs. Life Insurance

All life insurance policies are subject to the 7-pay test, and any time there is a material change to a policy (such as an increase in the death benefit), a new 7-pay test is required. Whether from a life insurance policy or a MEC, the death benefit received by the beneficiary is tax free.

3. Distributions

The following are taxation rules that apply to MEC's cash value:

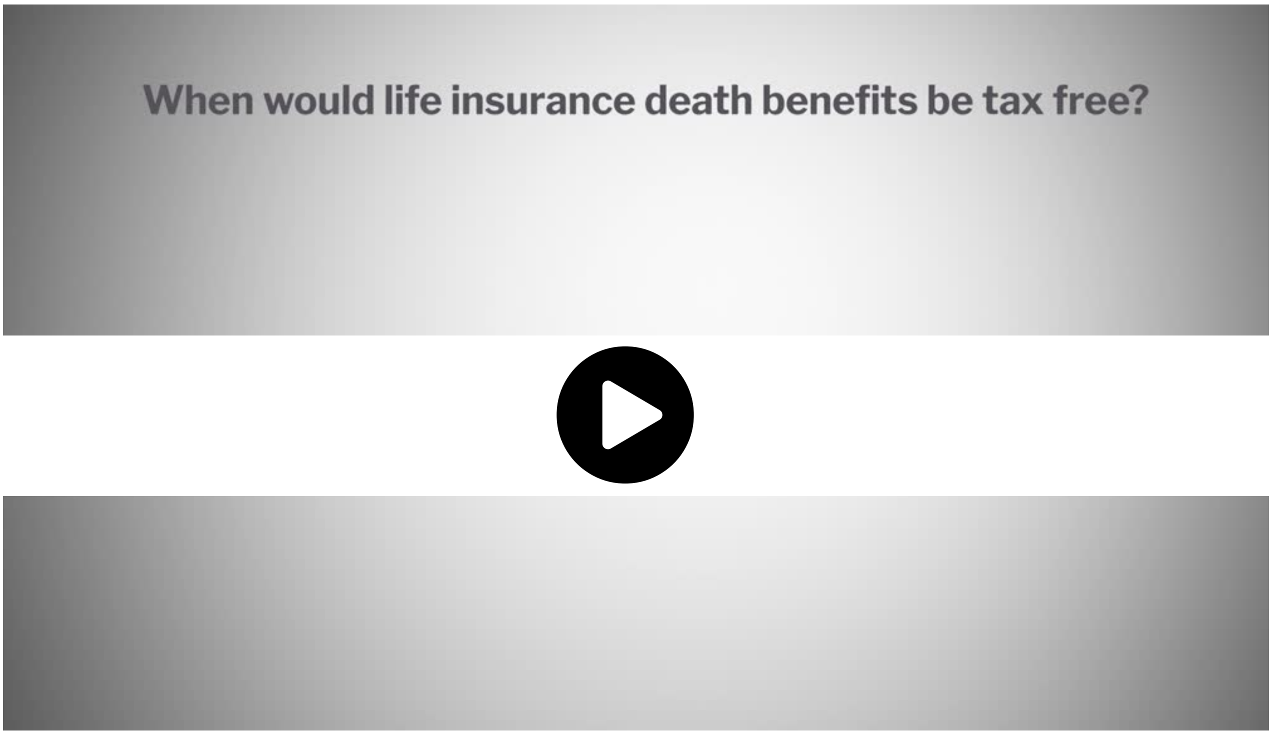
- Tax-deferred accumulations;

- Any distributions are taxable, including withdrawals and policy loans;
- Distributions are taxed on LIFO basis (Last In, First Out) — known as "interest-first" rule; and
- Distributions before age 59 ½ are subject to a 10% penalty.

F. Chapter Recap

This chapter explained the basic taxation principles for life insurance and annuities. Let's recap the taxable, tax-deductible and tax-free features and transactions:

TAXATION	
Life Insurance	• *Premiums* - not tax deductible • *Cash value* - taxable only if the amount exceeds premiums (taxed on gain) • *Policy loans* - not taxable, interest not tax deductible • *Dividends* - not taxable as return of premium; any interest is taxable • *Accelerated benefits* - tax free • *Death benefit* - not taxable if lump-sum; any interest is taxable • *Surrenders* - taxable if the cash surrender value exceeds the amount of the premium paid
Annuities	• *Accumulation* - tax deferred in individual annuities, not tax deferred in corporate owned • *Withdrawal of principal and interest* - Last In, First Out basis • *Lump-sum cash surrenders* - taxable • *Premature distribution* - tax and 10% penalty • *Distributions at death* - interest taxable
IRAs	• *Contributions* - pretax, tax deductible (must be made in cash) • *Earnings* - tax deferred • *Distributions* - taxable; 10% penalty for early withdrawals
Roth IRAs	• *Contributions* - after-tax, not tax deductible • *Distributions* - not taxable
OTHER RELATED CONCEPTS	
Rollovers and Transfers	• Tax-free transactions • Distribution of money from one qualified retirement plan to another • Must be completed within 60 days • If from plan to the participant, 20% of distribution is withheld • If from plan to trustee, no withholdings (direct rollover)
Modified Endowment Contract (MEC)	• Overfunded life insurance policy (7-pay test) • Accumulation - tax deferred • Distributions - taxable Last In, First Out • Distributions before age 59 ½ - 10% penalty



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