

## Planning Ideas—Life Insurance Cash Values and Retirement Planning

A common planning strategy promoted by life insurance marketers involves the purchase of life insurance primarily for cash value accumulation. The idea is to take advantage of favorable tax rules to supplement retirement income through policy loans. A problem can arise when projected cash value increases are insufficient to carry the policy and continue the income stream.

### Background

There are several tax rules that *favor* this strategy.

- First, cash value increases are tax-deferred. For taxpayers in the highest income tax bracket of 35 percent, even a modest policy interest-crediting rate of 3 percent is the taxable equivalent of better than 4.5 percent.
- Second, policy loans from *true* life insurance policies are income tax free. The distinction is made between a true life insurance policy and a modified endowment contract, the latter of which is a policy with an extraordinarily high ratio of cash value to death benefit. How do you know whether a policy is a life insurance contract or a modified endowment? Essentially, advisors need to rely on the insurance company to make this determination. The policy illustration should disclose whether the contract is a modified endowment. Policy loans from modified endowments are treated as withdrawals and are taxable to the policy owner to the extent of “gain in the contract” (essentially the difference in total cash value and premiums paid).
- Third, death proceeds are income tax free.



### So what’s the problem?

The problem arises if the policy is cancelled or surrendered. At that point, the total cash value including loans and accrued interest in excess of the taxpayer’s basis is included in income. That could be a big tax hit in a single year. Worse yet, if the net cash value is less than the tax due, the taxpayer will have to pay the difference out of pocket.

Not a pretty scenario. No wonder insurance professionals refer to it as the “surrender squeeze.”

## McGowen v. Commissioner

The recent case of McGowen v. Commissioner, 108 AFTR2d 2011-6063 (September 2, 2011) illustrates the problem.

Here the taxpayer purchased a true life insurance policy for a single premium. Normally, a single premium policy would be a modified endowment, but the purchase was made in 1986, two years before Congress introduced modified endowment contracts into the vernacular. In 2004, after several years of heavy borrowing against the contract, the insurance company notified the policy owner that the policy was about to lapse, inasmuch as the policy loan exceeded the policy cash value. The insurer gave the policy owner the option of making a minimum loan repayment in order to avoid policy lapse. The policy owner chose not to repay the loan and, sure enough, the policy came crashing down. A while later, as required by law, the insurance company sent the taxpayer a Form 1099-R reporting as taxable income the difference between the total cash value including all amounts borrowed and the single premium on the policy.

*According to the Court, the debt was not discharged under IRC Section 108, but rather extinguished under IRC Section 72. The policy loan was non-recourse to the taxpayer and the policy was the sole source of loan repayment. Furthermore, the Court pointed out that for the insolvency exception to apply, the taxpayer must be insolvent immediately before discharge of indebtedness. To the contrary, the taxpayer had a net worth of nearly \$4,000.*

In a clever but futile effort, the taxpayer argued that the income was not attributable to lapse of the policy, but rather the discharge of indebtedness. Normally discharge of indebtedness owed by a taxpayer is also taxable income under IRC Section 108. An exception applies, however, if the discharge of indebtedness is due to the taxpayer's insolvency.

The Tax Court and the Tenth Circuit Court of Appeals wasn't buying it. According to the Court, the debt was not *discharged* under IRC Section 108, but rather *extinguished* under IRC Section 72. The policy loan was non-recourse to the taxpayer and the policy was the sole source of loan repayment. Furthermore, the Court pointed out that for the insolvency exception to apply, the taxpayer must be insolvent *immediately* before discharge of indebtedness. To the contrary, the taxpayer had a net worth of nearly \$4,000 prior to cancellation of the policy, rendering her argument, well, worthless.

### Bottom Line

Advisors should routinely review their clients' life insurance policies. This is especially true in an era where performance projected on illustrations just a few years ago is likely to fall short of

what was anticipated due to market conditions and where several insurers have received credit downgrades from ratings companies.

It's important to monitor actual performance compared to illustrated performance and evaluate the risk of adverse tax consequences.

No one wants to be the advisor who let Mrs. McGowen down.

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