

# TAXATION OF INSURANCE PRODUCTS

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## I. Taxation of Life Insurance Policies

### A. Types of Life Insurance

#### 1. Term insurance

Term life insurance furnishes a specific quantity of insurance protection for a specific period of time. The face amount of the policy is paid if death occurs during the term; otherwise, nothing is paid. Premiums increase with the age of the insured, reflecting greater insurance risk.

#### 2. Traditional whole life insurance

Whole life insurance typically is in force for the insured's lifetime. Premiums usually are "level." In early years, the premiums have an investment element, which is the excess over the current cost of insurance protection. In later years, the cost of insurance protection exceeds current premiums, and is paid out of the investment element. A whole life policy may be "paid-up" at a specified point. Such a policy may be a "single premium" policy.

#### 3. Universal life insurance

Universal life insurance is similar to whole life insurance except that the amount and timing of premiums, and the amount of the death benefit, are flexible. Generally, these contracts enable a rapid accumulation of cash value.

#### 4. Endowment life insurance

An endowment policy provides insurance protection for a term of years, and then, if the insured is still alive at the end of the term, pays the face amount to the policyholder.

### B. Qualification as "Life Insurance"

1. As mentioned above, whole life insurance contains an insurance element and a savings or investment element.

2. Interest credited as the investment element of insurance policies is not currently taxed to policyholders (the so-called "inside buildup"). Some policies may be considered investment-oriented, in that they provide for the accumulation of large, tax-free investment elements.

3. TEFRA, for the years 1982 and 1983, enacted temporary guidelines for determining if contracts qualify as life insurance contracts for purposes of excluding death benefits from income. Section 101(f).

4. The 1984 Act provides a definition of the term “life insurance contract” for tax purposes. See section 7702. The definition contains two alternative tests.
5. The first test is the “cash value accumulation test”
  - a. This test must be met by the terms of the contract.
  - b. Under the test, the cash surrender value must not exceed, at any time, the single premium required to purchase the benefits offered, at that time, by the contract.
  - c. In other words, the investment element of the contract cannot be excessive vis-a-vis the insurance protection provided. Whole life insurance contracts with “reasonable” interest rates will qualify under this test.
6. The second test imposes “guideline premium” and “cash value corridor” requirements.
  - a. This test has two parts. The test is a practical one that must be met at all times.
  - b. Under the “guideline premium” part of the test, the sum of all premiums paid as of any date cannot exceed an amount necessary to fund future benefits. This test ensures that the policyholder does not make premium payments in excess of amounts necessary to pay for the insurance protection provided.
  - c. Under the “cash value corridor” part of the test, the policy’s death benefit must be within an applicable percentage of the cash surrender value. For example, for a 55-year old policyholder a policy with a \$10,000 cash value must provide a death benefit of at least \$15,000. This test ensures that an excessive investment element does not accumulate.
7. If a policy does not meet the definition of life insurance, the policy is treated as a combination of term insurance and a taxable deposit. Section 7702(g).
  - a. Thus, income on the policy is currently taxed to the policyholder. The income equals the increase in cash value, plus the cost of insurance provided, less premiums paid.
  - b. Moreover, only the excess of the death benefit over the cash value is eligible for exclusion from the income of the beneficiary.

- c. Nevertheless, the contract will continue to be treated as a life insurance contract for life insurance company tax purposes.
  - d. The IRS may “waive” the failure to meet the tests of section 7702 if it was due to reasonable error and reasonable steps were taken to correct the error. LTR 9601039 (Oct. 5, 1995); LTR 9517042 (Jan. 31, 1995); LTR 9524021 (Mar. 21, 1995); LTR 9322023 (Mar. 9, 1993); LTR 9202008 (Oct. 31, 1991).
8. Section 7702 applies to contracts issued after 1984. Contracts issued in exchange for existing contracts after 1984 may be subject to the new definition.

C. Premiums Paid for Life Insurance

- 1. Premiums paid by individuals for life insurance or annuities are, in general, nondeductible personal expenditures. Section 262.
- 2. An employer that pays life insurance premiums, in order to supplement an employee’s income, generally may deduct the premium payments as a business expense. Section 162.
- 3. However, if the employer is the beneficiary of a life insurance policy on an officer or employee, the employer generally may not deduct premiums paid with respect to that policy. Section 264(a)(1).
- 4. Thus, premiums are not deductible on life insurance which names an employer corporation as the beneficiary and which is used:
  - a. to fund a buy-sell agreement providing for the redemption of the employee’s stock in the employer corporation at the time of the employee’s death.
  - b. to secure a loan to the employer.
- 5. An employee may have to report an employer’s premium payments as compensation income. Section 62.
- 6. However, if an employer provides group-term life insurance, employees can exclude from income a portion of the premiums paid by the employer. Employees must include in income only the cost of group-term insurance coverage that is in excess of the sum of (1) the cost of \$50,000 of insurance coverage plus (2) any amount of the cost paid by the employee. Section 79(a). See Example #27.
  - a. No amount is included in the employee’s income if the employer or a charity is the beneficiary. Section 79(b)(2).

- b. The rule applies to both active and retired employees. However, no amount is included in the income of terminated disabled employees. Section 79(b)(1).
- c. If the group-term insurance plan discriminates in favor of key employees (active or retired), such key employees do not get the income exclusion.

D. Interest Paid in Connection with Life Insurance

1. Subject to the “modified endowment contract” rules discussed below, a policyholder may receive a loan of the cash value held with respect to a life insurance policy. If the loan is outstanding at death, the loan reduces the amount of the death benefit paid.
2. Most interest on policy loans on life insurance policies of individuals will be nondeductible under the “personal interest” rules of section 163(h). If the loan is taken for investment purposes, the investment interest rules apply. Section 163(d).
3. No interest is deductible on indebtedness incurred to purchase or carry single-premium policies. Section 264(a)(2). Such policies include policies on which substantially all of the premiums are paid within 4 years of the date of purchase. Section 264(c).
4. In general, no interest is deductible on indebtedness to purchase or carry any life insurance policy, if the plan of purchase contemplates systematic borrowing of increases in cash value. Section 264(a)(3).
  - a. Limited safe harbor rules are provided Section 264(d).
  - b. A safe harbor is provided if 4 out of the first 7 annual premiums are not borrowed. Section 264(d)(1). But see, TAM 200213010 (Dec. 11, 2001) (concluding that policy loan interest was non-deductible by a corporate taxpayer despite the fact that premiums were paid without loans in four of the first seven policy years).
5. If an employer owns a life insurance policy covering the life of an employee, the issue is whether the employer may deduct interest on indebtedness with respect to the policy.
  - a. Formerly (through 1995), an employer could deduct interest on indebtedness with respect to a “key employee” up to \$50,000 of borrowing. Prior section 264(a)(4).
  - b. Some companies began large case COLI programs, insuring thousands of employees, and borrowing \$50,000 on each policy. Interest credited inside the contracts (say 9%) was less than the

interest paid on the borrowing (say 11%). However, because the interest paid was deductible, the after-tax interest rate (say 8%) created a positive return on the COLI program.

- c. In the 1996 Act, the interest deduction was generally repealed for interest paid after 1995. Section 264(a)(4). In a 1998 Technical Advice Memorandum, however, the IRS disallowed a company's interest deductions in connection with COLI policies for years prior to 1996. LTR 9812005 (Jan. 22, 1998). A number of companies have contested the IRS position outlined in the TAM.
  - (1) In Winn-Dixie Stores, Inc. v. Commissioner, 113 T. C. 254, aff'd, 254 F.3d 1313 (11<sup>th</sup> Cir.), cert. denied, 122 S. Ct. 1537 (2002), the Tax Court and the Third Circuit ruled in favor of the IRS and held that the COLI program at issue lacked economic substance and, thus, disallowed the taxpayer's policy loan interest deductions.
  - (2) In Internal Revenue Service v. CM Holdings, 254 B.R. 578 (D. Del.), aff'd, 301 F.3d 96 (3d Cir. 2002), the United States District Court in Delaware and the Third Circuit also held in favor of the IRS.
  - (3) In American Electric Power Co., Inc. v. United States, 136 F. Supp.2d 762, aff'd, 326 F.3d 737 (6<sup>th</sup> Cir. 2003), cert. denied, 124 S. Ct. 1043 (Jan. 12, 2004), the court again held in favor of the IRS. The taxpayer has filed a petition for a writ of certiorari.
  - (4) In the most recently litigated leveraged COLI case, the taxpayer prevailed at the trial level. Dow Chemical Co. and Subsidiaries v. United States, 250 F. Supp.2d 748 (E.D. Mich. 2003). On appeal, the Sixth Circuit reversed in favor of the government (1/23/2006).
  - (5) Another COLI case, Ameritech, was filed in the Tax Court in December of 2000 and settled in September of 2003.
- d. The deduction is retained for insurance on up to 20 "key persons," who are either officers or 20-percent owners of the employer. However, the amount of interest deductible cannot exceed that credited at specified rates. Section 264(e)(2) and (e)(4).
- e. Various phase-in and grandfather rules apply to existing indebtedness.
- f. Employers may seek to terminate the life insurance, since it produces a negative return without the tax deduction. Under a

relief provision, income on such a termination can be brought into income ratably over 4 years.

- g. For life insurance policies and annuity and endowment contracts issued after June 8, 1997 to other than natural persons, an interest expense disallowance rule applies to the portion of a taxpayer's interest expense "allocable to unborrowed policy cash values." Section 264(f).
- (1) A contract's "unborrowed policy cash value" equals the cash surrender value (disregarding any surrender charge) of the contract, less the amount of any loan with respect to such contract.
  - (2) The amount of interest expense "allocable to" the unborrowed policy cash values, for which a deduction is disallowed, is calculated as follows:  
  
aggregate amount of allowable interest expense without regard to sections 264(f), 265(b) and 291,  
  
multiplied by:  
  
taxpayer's average unborrowed policy cash values for contracts issued after June 8, 1997, over the sum of (1) the taxpayer's average unborrowed policy cash values for all contracts, and (2) the average adjusted bases of all other assets of the taxpayer.  
  
Section 264(f)(2).
  - (3) Exceptions to the pro rata interest disallowance rule are provided. Section 264(f)(4) and (f)(5). Importantly, one exception covers certain policies owned by an employer on the lives of its employees, officers and directors.

E. Interest Earned in Connection with Life Insurance

1. As stated above, the investment element of qualifying life insurance is not currently taxed to the policyholder.
2. However, if the Section 7702 definition of life insurance is not met, the investment income is taxed to the policyholder.
3. The tax-free "inside buildup" is the subject of current legislative options.

F. Withdrawals of Cash Value

1. Except in the case of a “modified endowment contract,” a policyholder that withdraws funds (prior to the death of the insured) from the cash value of a life insurance policy first recovers the “investment in the contract,” and then the investment earnings. Section 72(e)(5)(C). Withdrawals of the investment in the contract are not includible in income, whereas withdrawals of investment earnings are.
2. The investment in the contract is the sum of premiums and other consideration paid, minus the aggregate amount received under the contract prior to the withdrawal that was not subject to tax. Section 72(e)(6).
3. However, if there is a distribution during the first 15 years of the contract due to a decrease in future benefits, the distribution will be considered first out of investment earnings, and includible in the income of the policyholder to that extent. Section 7702(f)(7).
4. Moreover, the investment-first ordering rule does not apply in the case of “modified endowment contracts.”
  - a. Modified endowment contracts are defined as contracts entered into after June 20, 1988, that fail to meet a 7-pay test. Section 7702A. A contract fails the 7-pay test if the total of premiums paid for the contract at any time during the first 7 years exceeds the sum of the net level premiums that would have been paid by that date if the contract provided for paid-up future benefits after the payment of 7 level annual premiums.
  - b. In the case of such contracts, distributions are treated first as distributions of income on the contract, and loans are treated as distributions. Section 72(e)(10). Such distributions are subject to a 10 percent additional tax. Section 72(v).
  - c. The IRS has provided a procedure for correcting certain “inadvertent, non-egregious” failures to meet the 7-pay test. Rev. Proc. 2001-42, 2001-36 I.R.B. 212.
5. See Example #28.

G. Receipt of Death Benefits

1. Amounts paid under a life insurance policy by reason of the death of the insured generally are not includible in income. Section 101(a). Thus, the “inside buildup” escapes income taxation.
2. However, if the recipient of the death benefits has purchased the policy for value, then the benefits generally are taxable to the extent that they exceed

the amount paid for the policy plus any premiums subsequently paid.  
Section 101(a)(2).

3. There are two exceptions to this transfer-for-value rule (section 101(a)(2)(A)&(B)):
  - a. If the transferee's basis is determined by reference to the transferor's basis (e.g., a gift).
  - b. Transfers to the insured, a partner of the insured, or the insured's partnership or corporation (e.g., buy-sell contracts).
4. If death benefits are held by the insurance company and paid at a later date with interest, the exclusion for death benefits applies only to the principal and not to the interest. A prorated amount of each payment is considered to be a part of death benefits and is excluded from income. The remainder is included in income. Section 101(d). See Example #29.
5. Note that the section 101 income exclusion applies in full to post 1984 contracts only if they constitute life insurance as defined by section 7702. There is a similar rule applicable to universal life insurance issued before January 1, 1985. See section 101(f).
6. Accelerated Death Benefits
  - a. Under section 101(a), to be excluded from income, life insurance benefits must be paid by reason of the death of the insured. Life insurance benefits paid to someone terminally ill would not qualify for exclusion.
  - b. The IRS proposed regulations that would have allowed such benefits to qualify.
  - c. The 1996 Act enacted section 101(g), under which payments of death benefits to terminally ill and chronically ill persons are deemed paid by reason of death.
  - d. Payments of death benefits include the proceeds of sales to viatical settlement providers. Section 101(g)(2).
  - e. Terminally ill persons are those expected to die within 24 months. Section 7702(g)(4)(A). Chronically ill persons are those with restricted ability to care for themselves. Section 7702B(c)(2).
  - f. Benefits received by chronically ill persons are excludible only up to specified limits. Section 101(g)(3).

- g. The exclusion does not apply to benefits paid to an employer with respect to a terminally ill or chronically ill employee. Section 101(g)(5).

#### H. Split Dollar Contract Arrangements

1. There are several variations of these plans, under which the employer and the employee share the benefits payable, and may share the premiums due, under the life insurance contract.
2. For years prior to 2002:
  - a. The employee is taxed on the value of the economic benefit received from the employer's participation in the arrangement, as measured by the cost of insurance protection provided. Rev. Rul. 64-328, 1964-2 C.B. 11 (applying one-year premium rates ("P.S. 58" rates) set forth in Rev. Rul. 55-747); Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12. Such benefits also include any policyholder dividends. LTR 9604001 (Sept. 8, 1995).
  - b. The employer may not deduct its portion of the premium. Section 264(a)(1); Rev. Rul. 64-328, supra.
  - c. The death benefits received by the employer and the employee are excludible under section 101.
3. In Notice 2001-10, 2001-5 I. R. B. 459, the IRS revoked Rev. Rul. 55-747 (and, implicitly, Rev. Rul. 64-238) and issued interim guidance regarding the tax treatment of split-dollar arrangements. Notice 2001-10 set forth a new table of one-year term insurance premium rates to be used in lieu of the P.S. 58 rates for determining the current value of life insurance protection under split dollar arrangements for tax years ending after January 31, 2001. The Service received many unfavorable comments from tax practitioners regarding this Notice.
4. In Notice 2002-8, 2002-4 I.R.B. 398, the IRS revoked Notice 2001-10 and announced that it would issue propose regulations that would govern the taxation of split-dollar arrangements using one of two mutually exclusive regimes -- the economic benefit regime or the loan regime. Notice 2002-8 also provided interim guidance for split-dollar arrangements.
5. In Notice 2002-59, 2002-36 I.R.B. 481, the IRS targeted certain split dollar arrangements where the donor retains current insurance protection as "understating the value" of policy benefits conferred and distorting the income, employment, and gift tax consequences of such arrangements. For such arrangements, the table set forth in Notice 2002-10 or the insurer's published premium rates (if lower) may not be used to value the policy benefits conferred upon the donee.

6. Final split dollar regulations implementing the economic benefit and loan regimes were published on September 17, 2003, and made effective as of that date. See Treas. Reg. §§ 1.61-22; 1.7872-15. The regulations apply to split dollar arrangements between employers and employees, donors and donees, service providers and recipients of services (independent contractors), and corporations and shareholders.
  - a. The economic benefit regime applies to life insurance contracts where the employer is the owner of the contract.
    - (1) Under this regime, the employee must report compensation income each year equal to the sum of (1) the cost of current life insurance protection provided to the employee, (2) the amount of policy cash value to which the employee has current access (to the extent not taken into account in a prior taxable year), and (3) any other economic benefits not taken into account in a prior taxable year. Treas. Reg. § 1.61-22(d)(2).
    - (2) Death benefits paid to the employee's beneficiary are excludible under section 101 (a) only to the extent that the employee paid the cost of such insurance, or the employee took the value of current life insurance into income as described above.
  - b. The loan regime applies to life insurance contracts where the employee is the owner of the contract.
    - (1) Under this regime, the employer is treated as the lender, and the employee is treated as the borrower, of amounts paid directly or indirectly by the employer pursuant to the split dollar arrangement if three conditions are satisfied: (1) a payment (including a premium payment) is made by the employer to the employee; (2) the payment is a loan under general principles of Federal tax law, or a reasonable person would expect repayment in full; and (3) the repayment is to be made from, or is secured by, the policy's death benefit proceeds, the cash surrender value, or both. Treas. Reg. § 1.7872-15(a)(2).
    - (2) Interest income may be imputed (if the split dollar loan is a "below market" loan). OED rules may apply.
7. The IRS has challenged "charitable" split dollar arrangements. See, e.g., Addis v. Commissioner, 2004-2 U. S. T. C. ¶50,291 (9th Cir.) (Disallowing charitable deduction with respect to charitable split dollar arrangement).

## II. Long Term Care Insurance Contracts

- A. The 1996 Act provides rules for insurance contracts that cover long-term care services, which are services provided to a chronically ill person by a qualified provider. Section 7702B.
- B. To be qualified, the contract must be guaranteed renewable, not provide a cash surrender value, and not cover expenses reimbursable under Medicare. Section 7702B(b).
- C. A qualified long-term care insurance contract is treated as an A&H contract. Section 7702B(a).
  - 1. For the policyholder, amounts received as benefits are treated as received for personal injuries and sickness and are excluded from income under section 104, up to a specified limit (\$175 per day, or \$63,875 annually, indexed in accordance with section 213(d)(10)).
  - 2. For the insurer, the contract is treated as an A&H contract.
- D. If the covered individual buys the coverage, the premiums paid are considered medical expenses that are deductible subject to the section 213(d)(10) limitation and the overall AGI limitation of section 213(a). See also, Rev. Proc. 2001-13, 2001-3 I.R.B. 337. (The premiums are partially deductible by self-employed individuals through 2002, and fully deductible thereafter.) The benefits received by the employee are excluded from income subject to the specified limit.
- E. If an employer provides the coverage, the employer can deduct the premiums, the premiums are not income to the employee (unless provided through a cafeteria plan or FSA), and benefits received by the employee are excluded from income subject to the specified limit.
- F. Benefit payments in excess of the specified limit are excludible only to the extent of actual costs. Amounts in excess of actual costs constitute income.
- G. Unreimbursed long-term care expenses are treated as medical expenses (subject to the AGI limitation of section 213(a)).

## III. Taxation of Annuity Policies

- A. Annuities
  - 1. In general, annuities are contracts under which an insurance company, for consideration, agrees to make specified payments either for a fixed period or for a designated lifetime. Most annuities contain a refund feature, which provides that, in any event, a minimum amount will be paid.

2. Consideration is paid during the accumulation phase of the contract. At the annuity starting date, the pay-out phase of the contract begins.

**B. Interest Paid in Connection with Annuities**

1. The section 264 interest rules discussed above also apply to annuities. Rev. Rul. 95-53, 1995-2 C.B. 30 (if an annuity is pledged to obtain a mortgage loan, an allocable portion of the interest paid on the mortgage loan is not deductible).
2. Amounts borrowed from annuity contracts are not treated as loans, but as withdrawals (see discussion infra).

**C. Interest Earned in Connection with Annuities**

1. In general, annuity holders are not taxed on the “inside buildup” of investment income.
2. However, if the annuity holder is a nonnatural person (e.g., a corporation) the contract is not treated as an annuity for tax purposes and the income on the contract is currently taxable. Section 72(u). Some exceptions are provided (e.g., annuities held under a qualified plan). LTR 9322011 (Mar. 5, 1993); LTR 9316018 (Jan. 22, 1993); 9120024 (Feb. 20, 1991) (the nominal owner of the annuity can be a nonnatural person, as long as the beneficial owner is a natural person).

**D. Withdrawals Before the Annuity Starting Date**

1. Section 72(e) provides rules applicable to withdrawals prior to the annuity starting date.<sup>1</sup>
  - a. As to annuities issued after August 1982, withdrawals are treated as first out of investment income, to the extent thereof, and then out of the investment in the contract (“LIFO”).
  - b. As to annuities issued before August 1982, the new rule applies to investments in those annuities made after that date. (Thus, income on pre-August 1982 investment is grandfathered.)

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<sup>1</sup>Section 72(e) was amended by TEFRA, with respect to contracts issued after August 1982 and with respect to investments in any existing contract made after August 1982; again by the 1984 Act, with respect to contracts issued after January 1985; and again by the 1986 Act.

Pre-TEFRA annuities: Like the general rule for life insurance, withdrawals were treated as first out of the investment in the contract, and then out of investment earnings (“FIFO”).

- c. Moreover, a penalty generally is imposed on such withdrawals, equal to 5 percent of the amount includible in income, but only if the withdrawal was of income allocable to an investment made within the prior 10-year period. Section 72(q). Certain withdrawals are excepted from penalty (e.g., withdrawals after age 59-1/2).
2. Post-1984 Act annuities
  - a. As to contracts issued after January 1985, the penalty applies even as to withdrawals of investments made within the prior 10-year period.
  - b. Moreover, such contracts must contain distribution-at-death rules similar to those imposed in respect of IRAs. Section 72(s).
3. The 1986 Act increased the 5-percent early withdrawal penalty to 10 percent.
4. An exchange of annuities may result in the loss of favorable grandfather treatment.

E. Receipt of Annuity Payments

1. Amounts paid under an annuity contract after the annuity starting date consist of two elements: non-taxable return of investment, and taxable investment earnings.
2. The non-taxable portion is spread over the annuity period or annuitant's life expectancy by means of an "exclusion ratio" formula.
3. The "exclusion ratio" is the "investment in the contract" divided by the "expected return" under the contract as of the annuity starting date. Section 72(b)(1).
  - a. The investment in the contract is the sum of premiums and considerations paid, less any amounts received before the annuity starting date and not included in income. Section 72(c)(1).
  - b. If the annuity contains a refund feature, the value of that feature as of the annuity starting date is subtracted from the investment in the contract. Section 72(c)(2).
  - c. The expected return is the sum of the payments due over either a period certain or the annuitant's life expectancy, as the contract provides. Section 72(c)(3).

4. Each annuity payment is multiplied by the exclusion ratio: the result is excluded from income, the remainder is included in income.
5. See Examples #30, 31, and 32.
6. Any withdrawal after the annuity starting date is includible in income in full. Section 72(e)(2)(A). Thus, the investment in the contract and the exclusion ratio are not recomputed.
7. In the case of long-lived annuitants, the amount excluded from income cannot exceed the investment in the contract. Section 72(b)(2).
8. In the case of short-lived annuitants, the amount of the unrecovered investment in the contract is allowed as a deduction to the annuitant for his last taxable year. Section 72(b)(3).

#### IV. Variable Contracts

- A. “Fixed” contracts accumulate investment earnings at a fixed rate specified in advance. Variable contracts invest in segregated assets, which are accounted for separately from the insurance company’s general assets, and accumulate whatever earnings are attributable to those segregated assets.
- B. Variable contracts are defined as (section 817(d)) --
  1. Contracts that are backed by a segregated asset account (or separate account).
  2. Contracts that are annuities, life insurance, or group term life or A&H insurance on retired lives.
  3. Contracts under which the amounts paid in or out, or the benefits, reflect the investment return and market value of the segregated asset account.
- C. The reserve for the contract equals the value of the assets in the account. However, for purposes of computing the increase or decrease in reserves --
  1. Amounts added to reserves to reflect appreciation in value (realized or unrealized) are subtracted.
  2. Amounts subtracted from reserves to reflect depreciation in value (realized or unrealized) are added back. Section 817(a).
- D. Correspondingly, the basis of assets in the account are increased to reflect appreciation and decreased to reflect depreciation.

- E. A variable contract will not be treated as an annuity or life insurance contract if the assets in the segregated account are not adequately diversified. Section 817(h).
1. The purpose is to avoid use of these products primarily to shield the investment income of specifically targeted investments.
  2. Several diversification standards and a safe-harbor rule are provided. Treas. Reg. §1.817-5(b) & (f).
  3. There are “look through” rules that allow the segregated account to invest in regulated investment companies, and to be treated as if the account held the assets of the RIC. Rev. Rul. 2005-7. Rev. Rul. 2007-58.
  4. If the diversification standards are not met, the income on the contract is currently taxed to the policyholder. Treas. Reg. § 1. 817-5(a). Compare Rev. Rul 2003-91,2003-33 I. R.B. 347 (variable life insurance and annuity contract holders not treated as owners of contracts because interests in sub-accounts of separate accounts are not available for sale to the public) and Rev. Rul. 2003-92, 2003-33 I.R.B. 350 (variable life insurance and annuity contract holders treated as owners of partnership interests funding a variable contract because partnership interests available for purchase by the general public). See also LTR 200244001 (May 2, 2002) (concluding that certain variable life insurance contracts did not meet the diversification standards where interests in private investment partnerships and money market funds backing the subaccounts of the segregated asset account were available to the “general public,” with the result that contract holders were treated as the owners of these investments and, thus, had to report gains and losses on the investments).
  5. Notice 2000-9, 2000-1 C. B. 449, provides relief for certain contracts that fail to meet the diversification standards.
  6. Notice 2008-92, 2008-43 I.R.B. 1001, provides relief for money market funds participating in the Temporary Guarantee Program, which is provided by the Treasury Department in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund to certain money market funds. The Notice provides that for purposes of determining whether a segregated asset account is adequately diversified, each United States government agency or instrumentality is treated as a separate issuer.
- F. The IRS has ruled that only cash, and not assets, may be transferred from the general account to the separate account. Rev. Rul. 73-67, 1973-1 C.B. 330. However, this ruling was revoked in 1997. Rev. Rul. 97-46, 1997 46 I.R.B. 7. As a result, a life insurance company may transfer assets other than cash to a segregated asset account for qualified pension plans.

V. Modified Guaranteed Contracts

- A. Modified guarantee contracts are variable-like contracts that do not qualify as variable contracts under section 817 because they provide for a guaranteed interest rate for some period of time.
- B. In the 1996 Act, section 817A was enacted to accord special treatment to these contracts.
- C. To qualify, assets under the contract must be held in a separate account, and the reserves for the contract must be valued at market value. Section 817A(d)
- D. Assets in the separate account are marked-to-market. Thus, each year the assets are treated as if sold, and any gain or loss is taken into account as ordinary income or loss. Section 817A(a). (Any such gain or loss is excluded when the asset ultimately is sold.)
- E. Mark-to-market gains and losses offset reserve increases and decreases each year. In contrast, under section 817, there is no gain or loss recognized and no reserve increase or decrease is taken into account. Thus, sections 817 and 817A achieve similar net results with different adjustment methods.

VI. Partial Annuitization Rules

- A. Section 72(a)(2) allows holders of annuities to elect to receive a portion of an annuity contract in the form of a stream of annuity payments, leaving the remainder of the contract to accumulate income on a tax-deferred basis.
- B. The holder of the annuity must receive amounts as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity, endowment, or life insurance contract.
  - 1. That that portion will be treated as a separate contract for annuity taxation purposes.
  - 2. For purposes of applying section 72(b) (dealing with the calculation of the exclusion ratio for annuity distributions), section 72(c) (definitions of “investment in the contract,” “expected return,” and “annuity starting date”), and section 72(e) (dealing with the taxation of distributions from an annuity, endowment, or life insurance contract, that are not received as an annuity), the investment in the contract will be allocated pro rata between each portion of the contract from which amounts are received as an annuity, and the portion of the contract from which amounts are *not* received as an annuity.
  - 3. In addition, a separate annuity starting date under section 72(c)(4) (which defines “annuity starting date”) will be determined for each portion of the contract from which amounts are received as an annuity.

## VII. Tax-Free Exchanges Of Policies

### A. Hypothetical situation

A taxpayer, age 29, obtains a whole life insurance policy to ensure income for surviving family. At age 59, that taxpayer is more concerned about retirement income.

### B. Taxable solution

The taxpayer can surrender the life insurance policy, but any amount received in excess of the investment in the contract is includible in income. Section 61, 1001. The after-tax proceeds can be used to purchase the annuity.

### C. Non-taxable solution

Exchange the life insurance policy for the annuity policy, tax-free, under section 1035. A 1998 Administration proposal was introduced that would change this treatment for exchanges involving variable contracts.

### D. Qualifying exchanges

1. A life insurance contract may be exchanged for a:
  - a. life insurance contract,
  - b. endowment contract, or
  - c. annuity contract.
2. An endowment contract may be exchanged for an:
  - a. endowment contract, or
  - b. annuity contract.
3. An annuity contract may be exchanged for an annuity contract.
4. The IRS has ruled that the exchange of two flexible premium life insurance contracts for one variable deferred annuity contract constitutes a tax-free exchange under section 1035. LTR 9708016 (Nov. 20, 1996). See also, Rev. Rul. 2002-75, 2002-45 I. R.B. 812 (consolidation of two annuity contracts issued by different insurers); LTR 200243047 (July 30, 2002) (one annuity contract exchanged for two annuity contracts); LTR 9644016 (July 18, 1996) (same).
5. Exchanges involving less than 100% of the policy owner's interest in an annuity contract may also qualify for tax-free treatment. See Conway v.

Commissioner, 111 T.C. 350 (1998), acq., 1999-47 I.R.B. 573; Rev. Rul. 2003-76, 2003-33 I.R.B. 355.

E. Exchange Procedures

1. With life insurance policies, the insured under the old and new policies must be the same. With annuities, the contracts must be payable to the same person. See Rev. Rul. 90-109, 1990-2 C.B. 191. LTR 9542037 (July 21, 1995) (exchanges of single-insured policies for a second-to-die policy are taxable).
2. The old and new policies may be issued by different insurers. Rev. Rul. 72-358, 1972-2 C.B. 473.
3. The old policy should be assigned to the insurer of the new policy. Care must be taken not to “cash out” and thereby trigger taxable income. LTR 8310033 (Dec. 3, 1982).

F. Tax Results

1. No gain or loss is recognized on the exchange.
2. If “boot” is received, the rules of section 1031 apply, and gain is recognized to the extent of the fair market value of the boot.
3. The basis of the new policy is equal to the basis of the old policy, (1) less cash received, (2) less any loss recognized, (3) plus any gain recognized.
4. See Example #33.

G. Cautions

Pre-TEFRA and Pre-1984 Act annuities and life insurance contracts have grandfathered status. An exchange of such a policy for a new policy may, or may not, cause loss of favorable grandfather status. Rev. Rul. 85-159, 1985-2 C.B. 29.

- H. In response to recent insolvencies of insurance companies, the IRS has issued rulings allowing for exchanges of policies issued by troubled insurers. See Rev. Rul. 92-43, 1992-1 C.B. 288; Rev. Proc. 92-44 (as amended by 92-44A, 1992-1 C.B. 875).