Securian Financial®

Individual life insurance

Life insurance products issued by
Minnesota Life Insurance Company
Securian Life Insurance company

Financial professional guide

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Life insurance taxation

What is the legal definition of a life insurance contract?

To qualify as life insurance, a life insurance policy must satisfy one of two tests: the Cash Value Accumulation Test (CVAT) or the Guideline Premium and Cash Value Corridor Test (GPT).[1] If at any time the contract fails to meet the test, the policy will not be treated as life insurance and will lose its tax-favored treatment.

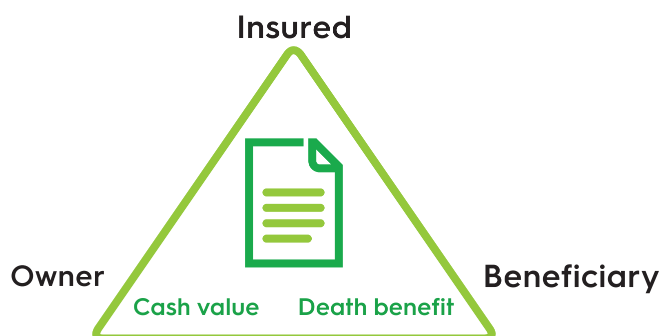
Test	Description	Commonly used for
Cash value accumulation test (CVAT)	An insurance policy will pass the CVAT requirements as long as the cash surrender value of the contract does not exceed the net single premium needed to fund the future benefits (death benefits on the primary insured) of the contract. The cash value accumulation test does not include additional coverage such as family term riders, accidental death benefits or waiver of premiums/charges.	Protection-focused cases
Guideline premium and cash value corridor test (GPT)	Under this test, two separate prongs must be satisfied to qualify as life insurance under this test: 1. Under the first prong, the cumulative premiums paid into the contract cannot exceed the greater of a guideline single premium or the total sum of the annual guideline level premiums for each year the policy has been in force. 2. The second prong is a cash value corridor test. The death benefit at all times must be no less than the cash value multiplied by a specified percentage set forth in the IRC.[2]	Accumulation-focused cases

Who are the parties to a life insurance policy?

Outside of the life insurance carrier, there are three different parties to the life insurance policy:

1. **Owner** - The owner controls the policy and has access to the cash value of the policy.
2. **Insured** - The insured is the measuring life of the policy.
3. **Beneficiary** - The beneficiary is the individual or entity designated to receive the death benefit when the insured dies.

PARTIES OF A LIFE INSURANCE POLICY



Are premium payments deductible?

No. Generally, life insurance premiums are not deductible regardless of whether the policy is owned personally or owned by a business.[3] As a general rule, life insurance premiums are not deductible if the premium payer has any interest in the policy or proceeds.

How is the internal cash value buildup taxed?

Generally, any increase in the cash value of a life insurance policy is not subject to current income taxation as long as the policy meets the statutory definition of life insurance. However, if a policy does not meet the definition, any increase in the cash value will be taxed as ordinary income annually as received or accrued by the policyholder.[4]

How are cash value withdrawals taxed?

In general, withdrawals from a policy's cash value are not taxed until the owner's entire investment in the contract has been withdrawn.[5] This is referred to as FIFO taxation (first in, first out). If all the investment in the contract has been withdrawn, any future withdrawals will be subject to income tax. There are three exceptions to this rule:

1. Policy doesn't fit within the definition of life insurance.
2. Policy is a Modified Endowment Contract (please see section on MEC).
3. Withdrawal occurs in the first 15 years with a reduction in benefits (please see section on DEFRA).

How are policy loans taxed?

Policy loans taken from a life insurance policy are not taxable transactions unless the policy is a modified endowment contract.[6] If the insured dies whiles the loan is outstanding, the loan will be repaid out of the death benefit and no taxation should occur. Please remember, there may be tax ramifications if the policy is surrendered, lapses, or exchanged with the loan still outstanding.

What are the tax ramifications if the policy is surrendered?

If the policy is surrendered, the cash value will be taxable as ordinary income to the extent that it exceeds the owner's investment in the contract.[7] Any loss incurred is non-deductible as personal expense.

Two-step process

1. Figure out the investment in the contract.

Generally, the investment in the contract is the total premiums paid less the total amount of untaxed distributions. Untaxed distributions include cash dividends paid and withdrawals.[8] Policy loan transactions do not affect the cost basis of the policy.

2. Subtract the investment in the contract from the net surrender value.

For example, assume the policy is a **Non-MEC.** *George, age 50, pays $1,000/year for 10 years on his policy. He withdraws $2,000 from the policy in year 8. In addition, later that year, he surrendered the policy when the net surrender value was $12,000.*

Premiums paid	**$10,000**
Less withdrawal	**$2,000**
Investment in contract	**$8,000**
Net surrender value	**$12,000**
Less investment in contract	**$8,000**
Taxable income	**$4,000**

This is a hypothetical example for illustrative purposes only.

How is the death benefit income taxed?

In general, life insurance death benefits are received income tax-free.[9] However, there are some situations **where life insurance death benefits may be taxable,** such as:

1. If the policy fails to meet the definition of life insurance.
2. If the policy is transferred for valuable consideration and no exception applies (please see section on transfer for value).
3. If the policy is employer-owned and does not qualify for an exception under Section 101(j) (please see section on employer owned life insurance — notice and consent).

How is the death benefit estate taxed?

In general, the death benefit will be subject to estate taxation in the insured's estate in the following situations:

1. Insured held incidents of ownership in the policy

Life insurance proceeds are includible in the insured's estate if the insured possessed any incidents of ownership or if the proceeds are payable to, or for the benefit of, the insured's estate.[10] Incidents of ownership include any rights to the economic benefits of the policy, including:[11]

- The power to change the beneficiary.
- The power to surrender or cancel the policy.
- The power to assign the policy.
- The power to revoke an assignment.
- The power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy.
- A reversionary interest in the policy.

Please note, absent from the list is the payment of premiums. Payment of premiums by the insured will not cause any part of the policy proceeds to be includible in the insured's gross estate.[12] If the decedent had the right to exercise any of these incidents of ownership alone or jointly with another person, the policy's value will be included in the estate. It makes no difference if the decedent was mentally or physically incapable of exercising an incident of ownership prior to death; the mere existence of the incident of ownership is enough to cause the policy to be taxed in the estate. The IRS has agreed that the right to convert a group term life insurance policy into a permanent policy upon termination of employment is not an incident of ownership.[13]

2. Insured held incidents of ownership in the policy within three years of death

Please see section on the three-year rule.

3. Proceeds payable to/for the benefit of insured's estate

Life insurance proceeds will be included in the decedent's gross estate if they are paid to the estate or applied for the benefit of the estate.[14] If the trustee is under a binding obligation to pay the debts, taxes and other charges against the estate, then the amount of the proceeds needed to pay those costs is included in the decedent's estate. This is true even if the proceeds are not actually used for this purpose.[15]

Modified endowment contracts

What is a MEC policy?

A modified endowment contract (MEC) is any life insurance policy that violates the seven-pay premium test (test period starts at issue and lasts seven years). In addition, another seven-year test period starts when a material change occurs, such as a face increase or future benefit addition.

What is the "necessary premium test"?

At any point during the contract, if the sum of the premiums hits the necessary premium test, the contract will experience a material change and a new seven-pay test will be triggered. This new seven-pay level may be lower than the previous level and less annual premiums will be allowed to avoid becoming a MEC.

For GPT-tested products, the necessary premium test level is basically the same as the definition of life insurance testing. The client cannot hit the necessary premium test without also violating the definition of life insurance, therefore no material changes occur because of the necessary premium test.

For CVAT-tested products, the necessary premium test is not the same test as the definition of life insurance, and a material change can occur on well-funded contracts.

What are the tax ramifications of a MEC policy?

Most important, a MEC policy will still retain income tax-free inside buildup and income tax-free death benefit. However, any lifetime distributions and/or loans from a MEC will be treated differently and taxed under the annuity rules.

Cash value distributions from a MEC are treated as coming from income first and cost basis last.[16] Therefore, unlike a cash withdrawal from a non-MEC policy, all withdrawals are taxable to the extent of the gain in the policy. In addition, "deemed distributions," such as policy loans and the pledging of a MEC policy as collateral are also treated as taxable distributions on a LIFO basis.[17] Furthermore, distributions made within the two years prior to the policy becoming a MEC will be treated as being made in anticipation of the policy's becoming a MEC and will be taxed LIFO as well.[18]

A 10 percent premature distribution penalty tax also applies to distributions from a MEC.[19] However, there are exceptions to the 10 percent penalty tax for MECs. The penalty will not apply if the distribution is made:

1. After the taxpayer attains age 59½, or
2. Due to a qualifying disability of the taxpayer, or
3. As part of substantially equal periodic payments made for the lifetime of or based upon life expectancy of the taxpayer.[20]

Examples

For example, assume the life insurance policy is a MEC.

George, age 50, pays $1,000/year for 8 years on his policy. He withdraws $2,000 from the policy in year 8 when the cash value is $10,000.	
Does George pay income tax on the $2,000?	**Yes**
Instead of withdrawing, what if he borrowed the $2,000?	**Yes**
What other tax ramification applies in this case?	**10 percent penalty tax because George is not 59½ yet.**

For example, assume the policy is a Non-MEC.

Does George pay income tax on the $2,000?	**No, but watch out for DEFRA (15-year rule).**
Instead of withdrawing, what if he borrowed the $2,000?	**No**

This is a hypothetical example for illustrative purposes only.

DEFRA recapture rules

What is the DEFRA recapture rules?

DEFRA is an acronym for the Deficit Reduction Act of 1984. This act introduced the 15-year rule with the intent to further discourage the use of life insurance as an investment vehicle (known as the DEFRA Recapture Rules). Violation of the 15-year rule modifies the tax treatment of withdrawals made during the first 15 years of a contract. The 15-year rule applies to a policy when, during the first 15 years of the contract, there is a withdrawal from the policy coupled with a reduction in benefits. Policy loans do not trigger the 15-year rule and are not considered withdrawals under this rule.

What are the tax ramifications?

Some or all of the withdrawal may be taxable. The taxable amount is calculated using formulas and recapture ceilings as specified under the Internal Revenue Code Section 7702. New illustrations and in-force ledgers will identify a DEFRA concern with a "£." This symbol merely signifies the potential violation of DEFRA.

The rules apply if all of the following conditions exist:

- The life insurance policy was purchased or acquired within the last 15 years (including tax-free exchanges).
- The face amount of the policy is decreased in conjunction with the withdrawal of cash value.
- There is a gain in the policy.

These rules don't apply to the following situations:

- The face amount remains level following the withdrawal.
- Policy loans.
- There is no gain in the policy.
- Withdrawals occurring after year 15.

Violation of these rules may result in a withdrawal of cash value being treated as taxable income. The amount that would be taxable is the LESSER of:

- The total gain in the contract (cash value less the investment in the contract), or
- The calculated recapture amount, or
- The amount of the withdrawal.

1035 tax-free exchanges

What is a 1035 tax-free exchange?

There may be circumstances where a policy owner may wish to exchange an existing policy for another policy that will better fit the client's current insurance needs. Under certain conditions, Section 1035 of the IRC provides that no gain or loss will be recognized on the exchange of a life insurance policy for another life insurance policy. Basically, in order to qualify for tax-free exchange treatment under Section 1035, the transaction must be a "like-kind" exchange.

When a 1035 exchange occurs, the basis in the old contract is "carried over" to the new contract.[21]

What are the definitions of life insurance and MEC testing implications of a 1035 tax-free exchange?

The cash value from the exchanged policy is treated as premium for the definition of life insurance testing under the guideline premium test. This means that the guideline single premium of the new policy must be higher than the cash value from the exchanged policy, plus any first-year premium.

The cash value from the exchanged policy is treated as cash value in the new policy for seven-pay testing purposes (MEC testing) under both the guideline premium test and the cash value accumulation test. This means that the 1035 exchanged value will lower the seven-pay number but does not create a MEC unless the exchange is from an already existing MEC contract. A new MEC contract can be created only if the 1035 exchange is from an already existing MEC, or if additional premium is paid into the new contract greater than the seven-pay number.

Please note, the exchange will start a new 7-pay MEC period and a new 15-year DEFRA recapture rule period for the exchanged policy. This new testing is regardless of when the original policy was issued (watch out for pre-1984 policies).

What are the elements for 1035 tax-free exchange?

In general, six elements must be met in order keep the exchange tax-free:

1. **There must be an exchange of one contract for another contract.** An exchange "requires that the taxpayer relinquish ownership in one insurance policy and, as a result thereof, acquire ownership in a second insurance policy."[22] It does not apply to the movement of policy funds from an existing policy into another existing policy. But it may be possible to exchange one policy for multiple policies, or multiple policies for one policy.[23]
2. **The insured(s) must be the same on both the old policy and the new policy.[24]** An exception is where an insured on a second-to-die policy is deceased and the surviving insured wants to exchange the policy for a single-life policy.[25]

Note: A 1035 tax-free exchange of one second-to-die policy to another second-to-die policy is acceptable if the owners and insureds are the same. A 1035 exchange of a first-to-die policy to a second-to-die policy does not satisfy this rule, because the insureds are not the same.

3. **The owner(s) on both the new and old contracts must be the same.**[26] However, transfers may be accomplished either prior to or following a tax-free exchange. Watch out for transfer-for-value and step transaction issues when transferring policies.
4. **The life insurance policy can be exchanged only for another life insurance policy, an endowment contract, an annuity or a qualified long-term care contract.**[27]
5. **A life insurance policy can only be exchanged from another life insurance policy.** An annuity cannot be exchanged for a life insurance policy.
6. **A MEC policy can only be exchanged for another MEC policy.**

What are the tax ramifications of the receipt of "boot" in a 1035 exchange?

If a taxpayer receives property, money or other non-like-kind property, other than a life insurance policy in a Section 1035 exchange, any gain in the policy will be recognized to the extent such property or money is received.[28] This is referred to as boot.

For instance, policy loans not carried forward to the new contract will result in taxation of the lesser of the gain in the old policy or the loan amount.[29] Further, withdrawals taken in conjunction with a 1035 exchange will result in taxation to the lesser of the gain in the contract or the withdrawal amount.[30]

Where the old policy's loan is carried forward to the new policy — that is, the new policy is issued with the outstanding loan — the transaction can be structured to be treated tax-free.[31]

Minnesota Life and Securian Life do not take policies with loans as a 1035 exchange.

Example: George has $8,000 in basis in his contract. He has $10,000 of cash accumulation value. He takes a loan for $3,000 from his policy, leaving $7,000 of cash surrender value. Subsequently, he decides to 1035-Exchange the policy for a different policy but does not carry it forward to the new policy.

Boot implications: George will need to recognize gain equal to the lesser of boot (the loan of $3,000) or the gain in the contract. To determine the gain in the contract, you will compare the difference between the policy's cash accumulation value ($10,000) and his basis in the old policy ($8,000). George will need to recognize taxable boot in the amount of $2,000 ($10k-$8k = $2k). The gain is $2,000, while the loan elimination is $3,000. Because George is taxed on the lesser of these two amounts, he will be taxed on $2,000.

This is a hypothetical example for illustrative purposes only.

Note: Independently, the loan elimination does not result in a taxable event, nor does the 1035 exchange. But when done in conjunction, taxation does result. This is due to the step transaction doctrine.

The step transaction doctrine basically dictates that a series of separate steps will be collapsed into one step, with the tax consequences applying to one step rather than each of them separately.

The IRS will view the use of policy values to pay down a loan, followed by an exchange, as a step transaction. Thus, a partial surrender and exchange is treated as an exchange with boot in an amount equal to the debt extinguished, and as a result, a taxpayer will be immediately taxed on the partial surrender to pay off the loan.

The risk of taxation may be diminished if a sufficient time gap occurs between the partial surrender of the policy values and the exchange itself. The IRS has not addressed what a reasonable time gap constitutes, so taxpayers are urged to consult with their tax advisor.

As a potential solution, the client could pay off the policy loan before the exchange by using other assets. The client could then borrow from the new policy as needed to replace the assets used or to pay off any other financing obtained.

What are the implications of policy withdrawals shortly before or after a 1035 exchange?

The boot treatment of withdrawals made from a policy either shortly before or after a 1035 exchange may be problematic. Typically, a taxpayer may treat withdrawals as tax-free returns of basis, up to a taxpayer's basis in the policy (if a non-MEC).[32] The IRS, however, has indicated that withdrawals made from a policy to pay off an existing policy loan, followed shortly by a 1035 exchange of the policy constituted a single integrated transaction taxable under code section 1035, resulting in tax on the withdrawal as boot (site). Interestingly, the IRS reached a different result in a private letter ruling involving the proposed pay-off of a policy loan after a 1035 exchange by using funds withdrawn from the new policy, holding that the subsequent policy withdrawal would be taxed under code section 72, not as boot under code section's 1035 and 1031.[33] A possible solution is to allow a sufficient amount of time (e.g., 6-12 months) to pass between any 1035 exchange and a policy withdrawal. If a withdrawal is required, it is likely better to make the withdrawal from the new policy after the 1035 exchange, which aligns with the IRS's favorable private ruling.

Transfer for value

In general, amounts received under a life insurance contract that are paid due to the death of the insured are excluded from gross income for federal income tax purposes under 101(a)(1). However, if a life insurance contract or interest therein is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the death benefit to the sum of the consideration paid for the contract or interest therein and any premiums and other amounts subsequently paid by the transferee.

What is the transfer-for-value rule?

The transfer-for-value rule, contained in Internal Revenue Code Section 101(a)(2), provides:

In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by [the beneficiary of death proceeds under a life insurance contract] shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

The transfer-for-value rule provides that when a policy is transferred for valuable consideration, the death proceeds received in excess of the consideration paid are taxed as ordinary income (as opposed to tax-free under the general rule for life insurance proceeds).[34] Consequently, running afoul of the transfer-for-value rule must be avoided at all costs.

Some points to remember:

- It does not matter whether the policy is term or permanent insurance.
- It applies to group as well as individually purchased life insurance coverage.
- The method of how the policy is transferred is irrelevant.
- It can apply even if ownership of a policy has not been transferred.
- A mere shift in an interest in the contract may be sufficient to trigger the rule.
- For the rule to apply there must be both a transfer of a policy or an interest in a policy and valuable consideration paid for that transfer to the transferor.

What are the five exceptions to the transfer-for-value rule?

There are five safe-harbor exceptions that may shelter a transfer from the transfer-for-value rule penalty (even if there is a transfer for valuable consideration). The "safe harbors" are:

1. Transferor's basis ("in whole or in part");
2. Transfer to the insured;
3. Transfer to a partner of the insured;
4. Transfer to a partnership in which the insured is a partner;
5. Transfer to a corporation in which the insured is a shareholder or officer.

Please note: Transfers to a co-stockholder are not protected and will trigger the transfer-for-value rule.

Implications of the Tax Cuts and Jobs Act of 2017 ("TCJA"):

TCJA modified the prior-law exceptions of the transfer for value rules to include a new reportable policy sale requirement applicable to all transfers for valuable consideration.[35] TCJA requires a determination that the transaction is not a reportable policy sale before deciding whether the transaction falls under existing exemptions to avoid the transfer-for-value rules tax liability.

The changes to the tax code do not alter the transfer-for-value rules, but rather add an additional layer of analysis. An in-depth analysis of these modifications is beyond the scope of this document.[36]

Goodman Rule

What is the Goodman Rule?

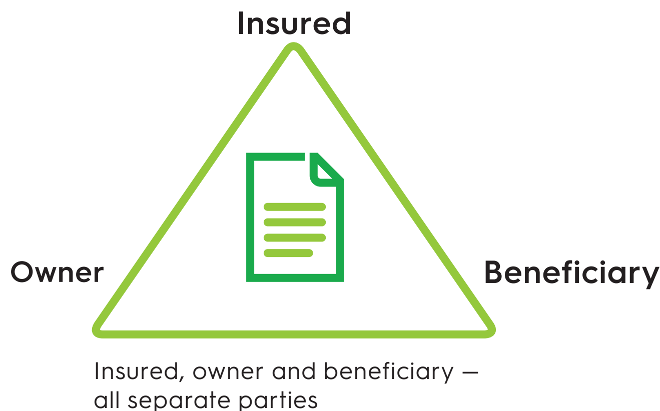
Watch out for the Goodman Rule (aka Unholy Trinity) where the owner, insured and beneficiary are all different individuals. The result of this arrangement will be a completed gift from the owner of the policy to the beneficiary when the insured dies or the beneficiary becomes irrevocable. This will cause gift tax issues for the owner.

Example

For example, let's say Son owns a policy on Father with Son and Daughter as the beneficiaries of the policy with a $2.0 million death benefit. If Father dies before Son, and Son is still the owner of the policy, then it will be treated for gift purposes as a $1.0 million gift from Son to Daughter.

This is a hypothetical example for illustrative purposes only.

GOODMAN RULE (Unholy Trinity)



In order to avoid the Goodman Rule, the policy will need to be owned by all of the beneficiaries in the same percentage as the death benefit they are to receive. This kind of co-ownership of life insurance policies can be cumbersome to arrange with the insurance companies.

Three-year rule

What is the three-year rule?

When the insured transfers an insurance policy or an interest in an insurance policy and dies within three years of that transfer, the death proceeds will be included in the insured's estate. Several cases suggest that when the trustee initiates the purchase and is the original owner of the policies, the three-year-rule is not applicable.[37]

To lessen the chance of an IRS challenge, some precautions can be taken:

- The trustee should initiate the purchase and apply for the insurance coverage.
- The trustee should not be required to purchase life insurance, only authorized or allowed to purchase life insurance.
- The grantor(s) should not make premium payments to the life insurance company, but instead should make cash gifts to the trustee.
- The trustee should make the premium payments to the life insurance company out of a separate checking account for the trustee.
- If possible, gifts to the trustee should be of an amount different from the annual premium and made before premiums are due.

The trust may be drafted with a safety-net provision in the event the insured dies within three years of the purchase of the policy and Section 2035 is applied. This provision would change the distribution scheme of the trust by giving the surviving spouse an interest in the proceeds, which would qualify for the marital deduction. Such a clause can postpone the estate tax on the proceeds until the surviving spouse's death to the extent not consumed or given away before that time. If the grantor transfers, without consideration, an insurance policy or any incident of ownership with respect to the policy during the three-year period preceding his or her death, the death benefit will be included in the insured's estate.[38] Practitioners should plan to avoid this problem where possible. Fortunately, it can be avoided in several different ways.

1. New policies

If it is a new policy, then use an informal inquiry to start the life insurance process. In one case, the insured submitted an application wherein the insured was listed as the owner. The application stated that the policy would not be issued until the premium was paid. A supplemental application was subsequently submitted with a child of the insured as owner and the premium paid. When the insured died a year later, the Service held that the insured never possessed an incident of ownership since the initial application stated that the policy would not be issued until the payment of premium.[39]

2. Existing policies

If it is an old policy, then consider:

Purchasing a new policy. Financial professionals should consider using a new policy rather than existing policy owned in the client's estate. The main reason for using a new policy is that a gift of an existing policy owned by the insured clearly falls under the three-year-rule. But the purchase of a new policy by the irrevocable trust will not be subject to the three-year-rule. Please note: financial professionals should consider the age and health of the insured, as a new policy may not be feasible if the insured is quite elderly or is in poor health.

The Estate Preservation Agreement (EPA). This rider helps reduce estate tax risk for transfer of a life insurance policy from the insureds to an Irrevocable Life Insurance Trust (ILIT). It provides additional term coverage for the first four years of the contract. This helps offset estate taxes if the policy is included in the insureds' taxable estate due to the three-year look-back rule for a transfer (or gift) of policy ownership. There is no charge for this agreement.

Notice and consent requirements for employer-owned life insurance

What is employer-owned life insurance (EOLI)?

An EOLI contract is defined as a life insurance policy issued after August 17, 2006, policyholder must include in gross income the death benefits received under an EOLI contract that exceed the total premiums and other amounts paid by the policyholder for the contract.

To fit within any exception to EOLI taxation, policyholders must satisfy certain notice and consent requirements prior to issuance of the EOLI contract. The IRS issued the following guidance regarding compliance with the notice and consent requirements.[41]

There are two exceptions:

1. An exception will apply if the insured under the contract was (1) an employee at any time during the 12 months prior to his or her death, or (2) a director or a highly compensated employee or individual at the time the contract was issued.[42]
2. Death benefits are either (1) paid to the insured's estate, family members, or other designated beneficiaries (other than the policyholder), or a trust for the benefit of any such individuals, or (2) used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described above. However, these exceptions are applicable only if the notice and consent requirements are met before the issuance of an EOLI contract.

What type of business strategies qualify as EOLI?

As a general rule, whenever a business entity will own a life insurance policy (including wholly owned corporations and sole proprietorships). Specifically in the business succession strategies:

Entity redemption buy-sell - The business owns the policy insuring the business owner and receives the death benefits to fund the owner's buyout.

Lifecycle LLC buy-sell - A separate partnership or LLC is used to hold life insurance on the owners of an operating business to fund the buy-sell of the operating business.

Key person life insurance - A business owns policy to protect it against the loss of a key employee, owner, director, etc.

Non-qualified deferred compensation plans - Any policy used to fund a non-qualified plan which is owned by the business. IRC §457(f) plans may have similar considerations.

Supplemental Executive Retirement Plans (SERPs) - Policies purchased as general asset reserves to fund non-qualified voluntary salary/ bonus deferral plans or supplemental executive retirement plans.

Endorsement split-dollar arrangements – Any policy where the business owns the policy, and the business (or a related person) will receive the death benefits. The IRS stated that life insurance policies issued in cross-purchase arrangements generally will not qualify as EOLI contracts for purposes of IRC Section 101(j).[43]

Please note: Changes or exchanges of grandfathered policies:

Any change to a grandfathered policy — or an IRC Section 1035 exchange of a grandfathered policy for a new policy if there is a material change (i.e., an increase in face amount or other benefit) — may require satisfaction of the Notice and Consent guidelines.

What is the notice requirement?

The employee must receive written notification that the applicable policyholder intends to insure the employee's life; reasonably expects to purchase a specified maximum amount of life insurance (stated either in dollars or as a multiple of salary) on the employee during the employee's tenure; and will be a beneficiary of any proceeds payable upon the death of the employee.

What is the consent requirement?

The employee must provide written consent to being the insured and to the continuation of coverage after termination of the insured's employment. The contract must be issued (1) within one year after the employee's consent or (2) before the termination of the employee's employment, whichever is earlier.

How do you comply with these EOLI rules?

EOLI compliance is the policyholder's responsibility. In any potential EOLI situation involving a Minnesota Life or Securian Life policy, there are two steps:

1. The employer must sign a copy of Minnesota Life's form F66015 or Securian Life's form FSL-66015, "Employer Notification Regarding the Potential Taxation of Death Benefits" before the policy is issued, and return it to the financial representative. This form simply notifies the employer of its potential obligations under these rules. It does not relieve the employer of its obligation to obtain a signed notice and consent from the prospective insured.
2. The client should discuss the EOLI rules with an attorney and, if the EOLI rules apply, obtain a signed notice and consent from the insured before the policy is issued. Minnesota Life and Securian Life have a sample "Insured's Acknowledgement of Notice and Consent — Employer-Owned Life Insurance Policy." It is the employer's obligation to obtain a signed form from each prospective insured before the policy is issued. The employer should retain these signed forms and file them along with their life insurance policies. The employer must also report these policies to the IRS annually by attaching completed Form 8925 to the employer's annual income tax return.

While the Service presumes that an employee will receive a separate form for notice and consent, a recent private letter ruling held that a separate document was not required where the totality of the applicable policyholder's documentation in connection with the EOLI contract evidenced that all the notice and consent requirements were met prior to contract issuance (specifically a buy-sell agreement and a life insurance application, both executed by the insured employee prior to issuance of the contract, which together contained all the required notice and consent information).[44] Accordingly, for existing EOLI contracts, an employer may be able to evidence notice and consent without separate documentation if it can demonstrate that all required notice and consent information was included in one or more documents that were provided to and/or executed by the insured employee prior to the contract's issuance. For newly issued contracts, however, obtaining a separately executed notice and consent form from the insured employee will more easily and clearly document compliance.

What are the annual requirements?

In addition, EOLI policyholders must file Form 8925 with their annual federal tax returns for each year that an EOLI contract is owned to report certain information regarding EOLI contracts, including the number of employees insured, the total insurance held under EOLI contracts and the number of non-consenting insured employees (if any). The policyholder must also keep whatever records may be necessary to evidence compliance.

What happens if the business inadvertently fails to satisfy the notice and consent requirements?

The only situations in which the IRS will not challenge inadvertent failures to satisfy the notice and consent requirements are if:[45]

- The applicable policyholder made a good faith effort to satisfy the notice and consent requirements (e.g., maintains a formal system for notice and consent for new employees);
- The failure to satisfy the requirements was inadvertent; and
- The failure to obtain the notice and consent was discovered and corrected by the due date of the tax return for the taxable year in which the EOLI contract was issued. (Failure to obtain consent cannot be corrected if the insured employee has died.)

Otherwise, removing the "taint" of an improperly issued EOLI contract often involves (1) cancelling the existing policy and issuing a new one or (2) affecting a material increase in the policy death benefit or other material change in the contract. The notice and consent requirements must be satisfied prior to the issuance of a new policy or to a material change in an existing policy.

Valuation of life insurance policies

How do you value a life insurance policy for income tax purposes?

The Service has provided a safe harbor on how to determine the fair market value of a life insurance policy for income tax purposes.[46] The fair market valuemay be the greater of either: (1) the interpolated terminal reserve and any unearned premiums or (2) the product of the "PERC amount" (PERC is premium, earnings and reasonable charges) and the applicable "average surrender value."

How do you value a sale of a life insurance policy for income tax purposes?

If a life insurance policy is sold by an owner (with insurable interest), to an unrelated party (without insurable interest), the seller is taxed on the difference between the selling price of the policy and the seller's adjusted costs basis. The adjusted cost basis will be the premiums paid for the policy less the cost of insurance charges paid. This is taxed as ordinary income up to the value that would have been received if the policy were surrendered and capital gain for the excess.[47] The purchaser will take a basis in the policy equal to the amount paid for the contract plus any additional premiums it pays. When a policy is sold, the transfer-for-value rules will in most cases cause the death benefit proceeds to become taxable in excess of the purchaser's basis in the policy.[48]

How do you value a life insurance policy for gift and estate tax purposes?

When an existing life insurance policy is gifted to an irrevocable trust, a taxable gift takes place.[49] The value of the gift is the fair market value of the policy on the date of transfer. This is the price that the property would bring when changing hands between a willing buyer and a willing seller. The fair market value is determined by reference to all the facts and circumstances relating to the transfer.[50]

Because there are no organized market forces available to determine the fair market value of a life insurance policy, the IRS issued regulations to provide guidance to what constitutes the fair market value of a life insurance policy for estate and gift tax purposes. The fair market value of the policy depends on the type of policy.

If the policy is a new policy (contracts transferred immediately after purchase or those within the first year), the fair market value is the "cost" of the policy.[51] The "cost" is the gross premiums paid by the transferor. If the policy is **an annual premium contract,** each premium thereafter is a gift.[52]

- **When a cash value policy is transferred with additional premiums being paid,** its fair market value is measured by the interpolated terminal reserve value on the date of the gift plus any unearned premium.[53] If there are accrued dividends on the policy, these must also be added. Outstanding policy loans should be subtracted from this value.[54]

- **If the gift is one of a single premium or an existing paid-up policy,** the value equals the single premium the insurance company would charge for a comparable contract issued at the insured's attained age at the time of transfer.[55] An employee can assign his or her group term insurance, made available by his or her employer, to an irrevocable trust. The gift is valued annually as the Table I cost of the coverage if the group plan is non-discriminatory.[56]

These regulations are only guidance and the IRS may review all the facts and circumstance relating to the transfer. Therefore, if an insured is in imminent danger of dying on the transaction date (any time within a year), the IRS may claim the policy to be valued at amounts closer to the death benefit payable.

For gift tax purposes, the value of the policy must be reported on IRS Form 709. Instructions for the form stipulate that if a value of a life insurance policy is being reported, IRS Form 712 should be attached for each policy. Typically, Form 712 is completed by the insurance company. The form comports with the IRS guidance on life insurance valuation and requires that certain values (interpolated terminal reserve and unearned premiums) be reported on the form.

How do you value the tax deduction for a gift of a life insurance policy for charitable purposes?

The valuation of the tax deduction for a gift of a life insurance policy depends how the policy was gifted.

Outright gift at death

The outright gift of a life insurance policy at death is a simple technique. The donor names the charity as the beneficiary of the life insurance policy. There is no current income tax deduction and the policy will be includible in the donor's estate (but will be offset by an estate tax charitable deduction). This approach may be suitable for a donor who plans to use the cash value of a policy for retirement income, but doesn't need the death benefit.

A gift of an insurance policy also provides estate tax benefits. One problem with transfers of life insurance policies is that a donor's estate will include a policy transferred by him within three years of his or her death.[57] The inclusion amount is policy's face value.[58] If, however, the donor transfers the policy to a qualified charitable organization, the estate qualifies for an estate tax charitable deduction equal to the face value of the policy, and this offsets the inclusion of the insurance policy in his or her estate.[59]

Gift of an existing policy during lifetime

An individual may transfer an existing life insurance policy to a charity. The donor is entitled to a current income tax deduction if the transfer is irrevocable and includes the donor's entire incidents of ownership in the policy. Please note: The charity must have an insurable interest in the donor's life under state law.[60] Please check your state law regarding insurable interest.

In order to take a charitable income tax deduction, the IRS does require the use of a qualified appraiser for charitable gifts of donated property with a fair market value of more than $5,000.00.[61] This includes gifts of life insurance.

Gift of policy on which premiums remain to be paid

The donor may get two deductions for their gift of a policy on which premiums remain to be paid:

First, the contribution of the policy is deductible at the policy's interpolated terminal reserve value on the date of the gift increased by the proportionate part of donor's last pre-gift premium payment covering the period beyond the gift.[62] If the interpolated terminal reserve value exceeds the donor's cost basis in the policy, then the deduction is for cost basis.[63]

Second, the continued payment of the premiums gives him or her an income tax deduction for the annual premium amount.[64]

A gift of a paid-up policy

The donor's gift of a paid-up policy to a charity results in a deduction valued at the policy's replacement cost.[65] If the replacement of the policy exceeds the donor's cost basis in the policy, the donor reduces his or her deduction to cost basis.[66]

Type of policy	The deduction is equal to the lesser of:
Recently issued	Cost basis or fair market value of the contract (defined as the first premium paid)
Existing life policy in premium paying mode	Cost basis or fair market value of the contract (defined as the interpolated terminal reserve plus unearned premium)
Paid-up life insurance policy	Cost basis or fair market value of the contract (defined as the replacement value of the contract – what donor would have to pay for a new single premium policy with the same death benefit at his or her current age)

Summary

Personal taxation issues

Event	Ramifications
Premium payments	Not deductible
Accumulation	Generally, tax deferred
Withdrawals	Non-MEC (FIFO Taxation) – Generally tax-free withdrawals up to basis and loans are non-taxable events MEC (LIFO Taxation) – Withdrawals are taxed similar to annuities; watch out for 10% penalty for clients under 59½ Surrender – Taxable as ordinary income on the extent that it exceeds the owner's investment in the contract
Death of insured	Generally, income tax-free but watch out for: • Estate tax issues • Three-year rule • Gift tax issues – Goodman Rule

Business taxation issues

Event	Ramification
Contributions	Who pays premium? Employer – Generally, not deductible Employee – Employer – Deduction for bonus (only for C corporations) Employee – Bonus taxed as income
Accumulation	Generally, tax deferred
Withdrawals	Business never age 59½, DEFRA
Death of insured	Generally, income tax-free but watch out for: • EOLI – Notice and consent • Transfer for value

1. IRC Sec. 7702(a). For all policies issued after December 31, 1984. Generally, policies issued prior to 1982 do not have a statutory definition of life insurance, but they must contain the traditional element of insurance, namely risk shifting and risk sharing.

2. IRC Sec. 7702(d)(2) lists the required corridor percentages by age.

3. IRC Sec. 264(a), Treas. Reg. Sec. 1.262-4(B)(1).

4. IRC Sec. 7702(g).

5. IRC Sec. 72 (e)(5).

6. IRC Sec. 72(e)(5).

7. IRC Secs. 72(e)(5)(A) & 72(e)(5)(E), Treas. Reg. Sec. 1.72-11(d)(1). See also IRC Secs. 61(a) & 72(a), Cohen v. Commissioner, 39 TC 1055 (1963), and Rev. Rul. 2009-13.

8. IRC Sec. 72(e)(6), Rev. Rul. 2009-13, Treas. Reg. Sec. 1.72-6(a)(1)15.

9. IRC Sec. 101(a)(1).

10. IRC Sec. 2042.

11. Treas. Reg. 20.2042-1(c)(2).

12. Rev. Rul. 71-497.

13. Rev. Rul. 84-130.

14. IRC Sec. 2042.

15. See Perry v. Commissioner 91-1 USTC Paragraph 60,064 (5th Cir. 1991); Estate of Headrick v. Commissioner, 90-2 USTC Paragraph 60,049 (6th Cir. 1990); Estate of Leder v. Commissioner 893 F.2d 237 (10th Cir. 1989).

16. IRC Sec. 72(e)(10).

17. IRC Sec. 72(e)(4)(A).

18. IRC Sec. 7702A(d).

19. IRC Sec. 72(v)(1).

20. IRC Sec. 72(v)(2).

21. RC Sec. 1031(d).

22. PLR 8810010.

23. PLRs 9644016 and 970816.

24. Treas. Reg. 1.1035-1(c).

25. PLR 9330040 ; PLR 9248013.

26. IRC Sec. 1035; Treas. Reg. 1.1035-1(c).

27. IRC Sec. 1035(a).

28. IRC Secs. 1035(c)(1), 1031(b).

29. IRC Secs. 1035(c)(1), 1031(b); Treas. Reg. Sec. 1.1031(d)-1(c).

30. Treas. Reg. 1.1031(d)-2.

31. PLR 9604033.

32. IRC Sec. 72(e)

33. PLR 8816015

34. IRC Sec. 101.

35. IRC Sec. 101(a)(3)

36. The final regulations were published on October 31, 2019 and are still under analysis

37. See Perry v. Commissioner 91-1 USTC Paragraph 60,064 (5th Cir. 1991); Estate of Headrick v. Commissioner, 90-2 USTC Paragraph 60,049 (6th Cir. 1990); Estate of Leder v. Commissioner 893 F.2d 237 (10th Cir. 1989).

38. IRC Sec. 2035.

39. See TAM 9323002. In TAM 9323002, life insurance proceeds were not included in an insured's estate where (1) the insured applied for the policy, (2) the insured then had the policy split into two policies and named her two sons as owners and beneficiaries prior to paying any premiums, (3) the insured's sons paid all premiums, and (4) the insured died within three years of purchase of the policy. The memorandum determined that under the terms of the contract and state law no contract existed prior to the time that the first premium was paid and the life insurance contract was issued and delivered. The memorandum also concluded that although it appeared that the decedent passed something of value to her two sons (i.e., although the insurance company's premium rates had increased between steps 1 and 2, the earlier lower premium rates were obtained by the sons), it was unlikely that such transfer constituted a transfer of incidents of ownership.

40. IRC Sec. 101(j). For this purpose: (1) a "related person" is any person with a relationship to the policy owner as specified in IRC §§267(b), 707(b)(1), 52(a) or 52(b); and (2) an "employee" is a U.S. citizen or resident who is an officer, director or certain highly compensated employees as defined in IRC §414(q).

41. Notice 2009-48.

42. For this purpose, (1) a "highly compensated employee" is defined in Code §414(q) but ignoring paragraph (1)(B)(ii) (i.e., any employee who is a 5% owner or had compensation from the employer in excess of $115,000 (inflation adjusted)), and (2) "highly compensated individual" is defined in Code §105(h) (5), but substituting 35% for 25% (i.e., an individual who is (a) one of the five highest paid officers, (b) a shareholder who owns (with the application of the constructive ownership rules of IRC §318) more than 10% of the employer's stock, or (c) among the highest paid 35% of all employees).

43. Notice 2009-48.

44. PLR 201217017.

45. Notice 2009-48.

46. Rev. Proc. 2005-25.

47. Rev. Rul. 2009-13.

48. Rev. Rul. 2009-14.

49. Treas. Reg. 25.2511-1(h)(8).

50. Treas. Reg. 25.2512-1.

51. Treas. Reg. 25.2512-6(a) Example 1.

52. Guggenheim v. Rasquin, 312 U.S. 254 (1941); Powers v. Commissioner, 312 U.S. 259 (1940).

53. Treas. Reg. 25.2512-6(a).

54. Treas. Reg. 20-2031-8(a)(2); Rev. Rul. 78-137.

55. Treas. Reg. 25-2512-6.

56. Rev. Rul. 76-490; Rev. Rul. 79-47; PLR 7751080.

57. I.R.C. §2035(a) & (d)(2).

58. I.R.C. §2042.

59. I.R.C. §2055(a).

60. See PLR 9110016.

61. IRC Sec. 1.170A-13(c)

62. Treas. Reg. §25.2512-6(a); Rev. Rul. 59-195.

63. I.R.C. §170(e)(1)(A).

64. Awrey v. Commission, 25 T.C. 643 (1955). See also PLR 8714037.

65. Treas. Reg. §25.2512(a).

66. I.R.C. §170(e)(1)(A).

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Life insurance products contain fees, such as mortality and expense charges (which may increase over time), and may contain restrictions, such as surrender periods.

Agreements may be subject to additional costs and restrictions. Agreements may not be available in all states or may exist under a different name in various states and may not be available in combination with other agreements.

Policy loans and withdrawals may create an adverse tax result in the event of lapse or policy surrender, and will reduce both the surrender value and death benefit. Withdrawals may be subject to taxation within the first 15 years of the contract. Clients should consult their tax advisor when considering taking a policy loan or withdrawal.

Dividends are not guaranteed and may vary based on the actual experience of mortality, expenses and investments.

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