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II. Federal Tax Treatment of Life Insurance and Annuities

The truth is the IRS needs taxes to pay for government, well, everything. The IRS will not take from both sides of the product though, so if the money is taxed before something is purchased then the benefit will not be taxed. If the money is tax deductible (so no taxes have been paid on it) or tax deferred, then the benefit will be taxable. It can get messy when you mix the two, for example in a deferred annuity. Then you have a mix of both taxable and nontaxable income from the same product.

A. Premiums are ***not tax deductible*** from the insured's income.

B. Cash Values accrue ***tax-deferred*** in any insurance product, whether it is an annuity or an insurance policy with cash value. (Paying taxes on surrender of the policy, only on any amount over and above the premiums paid).

C. Dividends are received ***tax free*** when a dividend is paid to a policy owner with a par or participating policy. You are participating in the profit of the company, *It is considered a refund of excess or surplus premiums.*

Stockholders receiving a dividend will be taxed as that is pure profit as an owner.

D. Settlements or Death Benefits (Proceeds) are ***federal income tax free to a beneficiary.***

- A life policy with no beneficiary means the proceeds go to the insured's ESTATE. This will lead to the value of the estate increasing and it now may be subject to federal estate tax.

- When a payout or settlement option is chosen any **interest earned** will be **taxable,** but the death benefit remains federal income tax free.
    - For example, I am concerned about a person's ability to control the lump sum of the death benefit, so I have a settlement option to pay out the funds over 20 years. The portion that is principal is not taxed since it is the actual death benefit. The portion that is growth is taxed since it is interest earned.

E. An annuity payout is the same as a settlement option with one exception. Generally, money being paid in to an annuity is done with after tax dollars so the return of the principle is not taxed. Since the money grows tax deferred, when the interest is paid out it is taxable. An annuitant may receive a check and 50% is principle and 50% is growth.

- The exception to this is when the annuity is inside the tax deferred bubble of a qualified retirement plan or a traditional IRA. When the money being paid in is tax deductible, the money coming out is all taxable.

F. Last In First Out (LIFO) or First In First Out (FIFO)?

- **The first amount credited to an account is the premium.**
- **The last amount credited to an account is always considered to be the interest or growth.**

Withdrawals are another means of obtaining funds from the cash value account. A ***partial withdrawal*** *(A.K.A. partial surrender)*, available on universal life policies or annuities without a life payout option chosen, does not have to be repaid to the policy.

- If the policy is a **universal** policy, premiums are allowed to be withdrawn first from the cash value so any withdrawals that exceed the premiums paid will be taxed. This is a FIFO, first in, first out, policy.
- If this is an **annuity**, the interest is paid out first when money is withdrawn. Since the funds have been growing tax deferred, the owner now owes taxes on the amount of interest withdrawn. Premiums are after tax dollar going in so they will not be taxed when being taken out and they will only be out of the account after all the interest is withdrawn. This is known as a LIFO or last in first out plan.
- If this is an annuity inside a qualified plan (401K for example) all of the money being paid in is tax deductible so all of the funds coming out will be taxed as they are withdrawn.
- If this is a **MEC,** the interest is paid out first when money is withdrawn. Since the funds have been growing tax deferred, the owner now owes taxes on the amount of interest withdrawn. Premiums are after tax dollar going in so they will not be taxed when being taken out and they will only be out of the account after all the interest is withdrawn. This is known as a LIFO or last in first out plan.
- All the plans may have a 10% tax penalty on the taxable amount if the owner is not 59 ½ that year.

- On the other hand, loans have zero tax consequences, but they do have to be repaid and they do accrue interest.

G. Surrenders and Withdrawals are similar in that both are taking money out. A withdrawal may also be called a partial surrender, the policy is still in force with a reduced face amount and the taxation is listed above.

A surrender gives up the policy completely. The tax consequences here being the premium is not taxed and the growth is. The exception to this rule is if a 1035 exchange is done. This is how a person may move from one cash value policy to another without incurring a tax debt. Whole life and universal policies can be replaced with each other, an annuity may be moved to another annuity. A life policies cash value may be moved to an annuity. An annuity may not be moved to a life policy though.

a) **1035 Exchange:** The Internal Revenue Code does provide for an exchange of one life contract for another, subject to certain requirements, in Code section 1035. If the requirements are met, the policyholder may exchange one contract for another (***including moving the cash value***) without incurring any current income taxation. Products exchange is Like to Like. For example: moneys moved from a 401K to an IRA, moneys moved from a whole life policy to a universal policy, universal to an annuity – both being life insurance products with a cash value- but not from an annuity to life insurance.

H. Modified Endowment Contracts (a.k.a. MECs)… This is essentially a life insurance policy that pays a death benefit to the beneficiary upon the death of the insured and has a cash value that can be withdrawn. The difference between a UL and a MEC is in the portion (premium or interest) of the money when it is withdrawn. A UL pays out the premium first, a MEC pays out interest first.

To counteract what was perceived as an abusive use of single-pay, limited-pay, and universal life policies as short-term, tax-sheltered, cash accumulation or savings vehicles, Congress passed legislation, effective in 1988, modifying the tax law definition of a life insurance contract, and created a new class of insurance contracts called MECs.

The test for MEC status is called the ***Seven-Pay Test***. A contract fails to meet the seven-pay test if it accumulates amounts paid under the contract at any time during the first seven contract years exceeding the sum of the "net level premiums." The IRS considers such contracts "***over funded,"*** such as single premium whole life.

For example, a policy has a net level premium of $1000 per year; If, in the first year there is more than $1000 in the cash value , during the second year there is more than $2000 in the cash value, during the third year there is more than $3000 the cash value, …up to 7 years it is a MEC. Once a policy is determined to be a MEC it is always a MEC. After 7 year if it is not classified as a MEC it never will be. *Yes, even if you trade it out for a new policy.*

The basic difference between MECs and other life contracts is the federal income tax treatment of amounts received *during the insured's life*. When received from MECs, certain distributions under the contract that are not generally subject to tax when received from other life contracts are subject to income tax and, in some cases, a 10% penalty. The 10% penalty applies to distributions taken before age 59½. **Amounts received under MECs are treated as income-first**, such as loans, withdrawals, and cash dividends. (They are taxed the same as "deferred annuities", LIFO).