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PERSONAL FINANCIAL AND TAX PLANNING WITH INSURANCE PRODUCTS AND COMPARABLE INVESTMENTS

WILLIAM B. HARMAN, JR.

I. FINANCIAL PLANNING WITH INSURANCE PRODUCTS

A. *Individual Life Insurance Products*

1. Tax Benefits To An Individual—In General

a. Since 1913, Congress has excluded from income the death proceeds of “life insurance” contracts. Section 101(a)(1) of the Code.*

(1) Until 1982, there was no definition in the Code of what constituted a “life insurance contract” for purposes of section 101(a).

(2) In the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), Congress provided in section 101(f) the first statutory definition of “life insurance” for Federal income tax purposes. Section 101(f), however, only addressed the so-called “flexible premium” life insurance contract. (See 2b below).

b. The Internal Revenue Service has recognized that increments in the cash values of such contracts could not be considered constructively received until maturity or surrender. Thus, for the individual taxpayer, the so-called “inside build-up” on a “life insurance” contract is not taxable currently to the policyholder.

c. Taxpayers are allowed to deduct interest paid or accrued on policy loans if they meet the safe harbor rules of section 264(c).

(1) Section 264(c) permits a deduction of the entire interest on loans incurred *if* (1) no part of four of the first seven annual premiums due under the contract is paid by means of indebtedness; (2) the total of the amounts paid or accrued by the taxpayer during the taxable year does not exceed \$100; (3) the indebtedness was incurred in connection with the taxpayer’s trade or business; *or* (4) such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or an unforeseen substantial increase in financial obligations.

(2) Use of policyholder loans as a means of obtaining tax sheltering of outside income through tax-deductible policy loan interest payments funded through tax-free investment earnings on a policy.

2. “New” Life Insurance Products

a. With the 1970’s came a series of “new” life insurance products which were designed to perform the traditional function of a whole life policy but in a more flexible and consumer-oriented form.

*Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as amended.

b. Universal Life Insurance

(1) Introduced by Hutton Life in 1978, universal life insurance provides full flexibility in premiums and benefit levels with the prospect of current interest credits and mortality charges. In addition, the net amount at risk is within the policyholder's control.

(a) Death benefit protection—need for only one policy throughout life. Hence, “plan of insurance” is not a factor.

(b) Provides competitive interest rates.

(c) Distribution through brokerage community in addition to traditional sales force. Provides for lower sales commissions.

(d) Ability of consumer to make cost and benefit comparisons.

(2) Income Tax Treatment

(a) In a private letter ruling in 1981, the IRS ruled that the death benefit was excludable from gross income under section 101(a)(1) and that the policyholder was not in constructive receipt of the cash value increments prior to actual surrender.

(b) In 1982, the Service indicated it was “re-examining” its earlier ruling and in GCM38934, the Chief Counsel of the IRS recommended that universal life should be viewed as a combination of term insurance and a savings-type arrangement, with only the insurance element being excludable under section 101(a)(1).

(c) In response to this “re-examination” by the Service, Congress (in TEFRA) added to the Code section 101(f).

(i) Section 101(f), which applies only to flexible premium policies (such as universal life policies), provides that such policies are to be treated as life insurance contracts for Federal tax purposes if certain guidelines are met.

(I) The guidelines are designed to impose premium and cash value limitations in order to preclude the application of life insurance tax treatment in the case of a policy used primarily for investment purposes.

(II) Applies *only* to contracts issued before January 1, 1984.

c. Variable Life Insurance

(1) Variable life insurance is a registered security *fixed* premium policy which was first introduced by The Equitable in the mid-1970's.

(a) Assets underlying the policy are invested in one or more variable funds held in a separate account.

(b) Earnings of the fund above the assumed minimum are utilized to acquire additional life insurance.

(c) Death benefits and cash values increase or decrease with reference to the fund's performance. The death benefit, however, is subject to a guaranteed minimum.

(i) Sharing in market performance may act as a means of enhancing policy values.

(2) Income Tax Treatment

(a) The death benefit is excludable under section 101(a)(1) and

the cash value increments (inside build-up) are not constructively received. Rev. Rul. 79-87, 1979-1 C.B. 74 and PLR 8120023.

d. Variable Universal Life Insurance

(1) "Variable universal" or "universal life II", which is now permitted under a model State regulation and is under study by the SEC, provides for the marriage of the universal life and the variable life concept—the flexible premium with the separate account product.

(a) The cash value increases (or decreases) with the performance of the underlying fund.

(b) The amount at risk and the death benefit are adjustable and may vary (according to the fund's performance) in amount, duration, or both.

(2) Income Tax Treatment

(a) As a "flexible premium" contract, the death benefit on a variable contract should be excludable if the contract meets the requirements of section 101(f).

e. Other Individual Life Insurance Products

(1) Adjustable Life Insurance

(a) Adjustable life insurance is a flexible premium policy which is patterned after the traditional whole life policy.

(b) If the adjustable life contract meets the requirements of section 101(f) of the Code, the death benefits under such contract are excludable from income.

(2) Indeterminate Premium Policy

(a) Permits premiums to change prospectively with anticipated interest credits and mortality charges.

B. Group Term Life Insurance

1. To be considered group term life insurance for income tax purposes, the life insurance must provide a general death benefit excludable from gross income under section 101(a) of the Code; must be provided to a group of employees as compensation for personnel services performed as an employee; must be provided under a policy carried directly or indirectly by the employer; and must provide that the amount of insurance for each employee is computed under a formula which precludes individual selection of such amounts.

2. Income Tax Treatment

a. Premiums paid by an employer for group term insurance on the lives of employees are deductible. Section 162(a); Rev. Rul. 56-400, 1956-2 C.B. 116.

b. The cost of group term life insurance coverage up to \$50,000 provided by an employer is not taxable to the insured employee. Section 79.

(1) The \$50,000 cap does not apply in the case of retired employees.

(2) If the group term plan covers any key employees and the plan discriminates in their favor either as to the eligibility to participate or with respect to the amount or kind of benefits, for tax years beginning after 1983, the key employees may not exclude from income the cost of the first \$50,000 of coverage.

(c) Death benefits paid on such contracts are not taxable income. Section 101(a).

C. Annuity Contracts

1. Fixed Annuities

a. In a fixed annuity contract, the insurance company agrees, for a cash consideration (in single or multiple premiums), to make specified payments during a fixed period or for the duration of a designated life (or lives).

(1) Modern fixed annuities provide for the crediting of current interest rates.

(a) Minimum rate is specified in the contract.

(b) The portion of the interest credited above the guaranteed minimum is characterized as the "excess interest."

(i) Excess interest may be guaranteed in advance for specified period.

(ii) Excess interest rate may be fixed by declaration of the company or by reference to some outside index (such as the Treasury bills rate).

b. Income Tax Treatment

(1) The policyholder is not taxed on interest or other current earnings on an annuity contract until annuity payments are received ("amounts received as an annuity") or amounts characterized as income are withdrawn.

(2) Amounts Received As An Annuity

(a) Amounts paid as an annuity are divided under an exclusion ratio with a fixed portion of each payment excludable from gross income as a return of the investment and the balance included as income and taxed at ordinary income rates. Section 72(b).

(b) Withholding

(i) Amounts received under an annuity contract are subject to withholding. However, the payee may elect not to have any amount withheld. Section 3405.

(3) Amounts Not Received As An Annuity

(a) Premature Withdrawals (or Partial Surrenders) From Annuity Contracts

(i) Prior to TEFRA, amounts received under an annuity contract prior to the annuity starting date were to be included in the taxpayer's income only to the extent such amounts exceeded the taxpayer's investment in the contract.

(ii) Under TEFRA, the ordering rule for premature withdrawals is revised. Section 72(e) now requires that partial withdrawals are to be includible in gross income to the extent the cash value (determined without regard to any surrender charge) exceeds the investment in the contract prior to the distribution.

(I) Applies only to annuity contracts issued after August 13, 1982, or investments in contracts made after such date.

(II) Policy loans and assignments of policies are considered to be distributions subject to the new section 72(e) rules.

(III) The pre-TEFRA rule continues to apply to qualified contracts, to individual retirement accounts and annuities, to amounts received upon a complete surrender, and to contracts issued before August 14, 1982, to the extent such amounts are allocable to premiums paid before August 14, 1982.

(b) **Penalty Tax on Premature Distributions**

(i) A 5 percent penalty tax is imposed on amounts includible in income under section 72(e) of the Code to the extent such amount is allocable to premiums paid during the preceeding ten years. Section 72(q).

(ii) For purposes of the penalty tax, a "first-in, first-out" rule applies. Thus, the amount included in income is allocated first to the earliest premiums paid with respect to which amounts have not previously been allocated.

(iii) The section 72(q) penalty does not apply in the case of the following distributions:

(I) Any distribution which is one of a series of substantially equal periodic payments made for the life of the taxpayer or over a period of at least 60 months;

(II) Distributions made after the taxpayer reaches age 59½;

(III) Distributions made on account of death or disability;

(IV) Distributions from a qualified contract; or

(V) Distributions allocable to premiums paid before August 14, 1982.

2. Variable Annuities

a. In a variable annuity, premiums are invested in units of a segregated investment account. As a result, the cash value of the contract fluctuates with the increase or decrease in unit value associated with the segregated investment account.

(1) At the annuity starting date, the total number of units credited to the contract are utilized to fund income payments.

(a) The dollar amount of each payment will fluctuate in relation to the dollar value of the unit when the payment is made.

b. Income Tax Treatment

(1) In general, variable annuities receive the same tax treatment as fixed annuities.

(a) Under the "traditional" variable annuity, the insurance company is considered the owner of the underlying assets and the policyholder is not currently taxed on the increments in the cash value.

(b) The rules on premature distributions and the penalty tax (discussed above) are also applicable to variable annuity contracts.

(2) The "Wraparound" Issue

(a) In recent years, the Service began questioning the tax deferral status of variable annuities which permitted policyholder control over the investment of the underlying assets.

(b) In a series of rulings beginning in 1977, the Service ruled that the policyholder "owned" such assets (and thus was currently taxable on the increments in the cash value) in the case of the savings and loan annuity, the investment annuity, and the mutual fund annuity. Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12; * Rev. Rul. 81-225, 1981-2 C.B. 12.

(i) Subsequent rulings in the mutual fund annuity area clarified what degree of "control" by the policyholder was allowable without the policyholder being deemed the "owner" of the underlying assets. Rev. Rul. 82-54, 1982-14 I.R.B. 5; Rev. Rul. 82-55, 1982-14 I.R.B. 6.

D. Impact Of Proposed 1983 Life Insurance Tax Act On Insurance Products

1. Prelude To Pending Legislation

a. In response to certain perceived difficulties in the operation of (and certain loopholes in) the 1959 Life Insurance Company Tax Act, Congress enacted in 1982 as a part of TEFRA certain legislative changes in Subchapter L and related provisions governing policyholder taxation.

(1) These changes addressed a variety of company tax concerns (modified coinsurance, deductibility of dividends and excess interest, etc.) and policyholder issues in the annuity contract and flexible premium contract areas.

(2) Except for the provisions relating to annuity contracts and modified coinsurance, the TEFRA changes are scheduled to expire on December 31, 1983.

b. Beginning in January, 1983, the House Ways and Means Committee, and in particular, its Select Revenue Measures Subcommittee, began the task of revising the existing life insurance taxing scheme with a view toward "simplification."

c. The Subcommittee, chaired by Congressman Pete Stark, reported

**See, Investment Annuity, Inc. v. Blumenthal, 442 F.Supp. 681 (D.D.C. 1977), rev'd, 609 F.2d 1 (D.C. Cir. 1979).*

in late September what became known as the "Stark-Moore Proposal" (the Life Insurance Tax Act of 1983).

2. Current Status Of Proposed Legislation

a. House Action

(1) The Stark-Moore Proposal was incorporated into the Tax Reform Act of 1983 (H.R. 4170) which was reported by the full Ways and Means Committee on October 6, 1983.

(2) Defeat of "rule" providing for consideration of H.R. 4170 on the House floor.

b. Senate Action

(1) On October 24, 1983, Senators Bentsen and Chafee introduced the so-called "Stark-Moore Proposal" on the Senate side as S. 1992.

(2) Senate Finance Committee failed to consider life insurance tax legislation prior to adjournment of 1st Session of 98th Congress.

3. Impact Of Stark-Moore Proposal (H.R. 4170) On Tax Treatment At Policyholder Level

a. Definition Of Life Insurance

(1) Proposed section 7702 of the Code would define the term "life insurance contract" for Federal tax purposes.

(a) Derived from section 101(f), which was applicable only to flexible premium contracts.

(b) Definition is intended to limit the use of life insurance policies as tax-favored investment vehicles.

(2) "Failed" Contracts

(a) If the contract fails to meet the section 7702 definitional test, it would be separated into two parts for Federal tax purposes.

(i) The insurance part (the difference between the face amount and the net surrender value) would be accorded the section 101(a) of the Code death benefits exemption.

(ii) Income earned with respect to net surrender value would be currently taxable to the policyholder.

b. Policyholder Loans

(1) Places limitations on the amount of interest deductible in any taxable year with respect to loans against life insurance policies held by individuals and businesses.

(a) In the case of an individual, the limit is an amount equal to \$250,000 (\$500,000 in the case of a joint return) multiplied by the deficiency rate under section 6621.

(b) For businesses, the annual limit is \$500,000 multiplied by the deficiency rate for each "qualified life."

(c) Excess limitation may be carried over and added to the limitation for the succeeding taxable year.

(d) Provision applies generally to any interest paid or accrued in taxable years ending after September 27, 1983.

c. Group Term Life Insurance

(1) Extends the \$50,000 limit on the exclusion from income for the cost of group term life insurance to retired employees.

(2) Extends the nondiscrimination rules of existing law to retired employees and prohibits key employees under discriminatory plans from using the uniform cost table for calculating the cost of their group-term insurance to be included in income.

(3) In general, these provisions would be applicable to taxable years that begin after December 31, 1983. However, provisions would not apply to plans in existence on September 27, 1983.

d. Annuity Contracts

(1) Amends section 72(q) of the Code by eliminating the 10-year holding period exception from the 5 percent penalty tax on premature distributions from an annuity contract.

(2) In addition, the bill would amend section 72 of the Code so as to require that, if the annuity has not been annuitized prior to the death of the holder of the contract, the income in the contract will be taxable upon such death and includible in the final return of the holder.

(3) Changes are effective for all contracts issued 6 months after date of enactment.

e. Other Provisions Impacting Policyholders

(1) Taxation of capital gains at company level in the case of variable contracts.

(2) Deductibility of policyholder dividends by mutual and stock companies.

II. FINANCIAL PLANNING WITH COMPARABLE PRODUCTS

A. Individual Retirement Accounts

1. An Individual Retirement Account (“IRA”) is a trust custodial account established by an individual through financial institutions (such as banks, insurance companies, and mutual funds).

2. Income Tax Treatment

a. Subject to specified limits, contributions to an IRA are deductible for Federal income tax purposes and earnings on such contributions also accumulate tax-free.

(1) Limits on Contributions

(a) Maximum annual deductible contribution by an individual is \$2,000 (\$2,250 if a non-working spouse is also covered). In the case of married taxpayers, each working spouse may have an IRA account and deduct a maximum of \$2,000. Section 219(b) and (c).

(i) If contributions are made in excess of the deductible limit, the contributing taxpayer may be liable for a non-deductible excise tax

of 6 percent of the amount of the excess. Section 4973(a). This excise tax does not apply to "rollover" contributions.

(ii) If the contributor will reach age 70½ during the taxable year, he/she may not make an IRA contribution for that year or any subsequent year.

(b) Contributions may be made at any time during the taxable year and until the contributor-taxpayer's Federal income tax return for the year is due.

(2) The Economic Recovery Tax Act of 1981 ("ERTA") provided that an individual may deduct voluntary contributions even though such individual is an "active participant" in a qualified corporate or Keogh pension, profit sharing, stock, bonus, annuity or bond purchase plan, in a 403(b) annuity, or in a government plan. Section 219.

c. Distributions

(1) In general, all amounts paid out of an IRA are taxed as ordinary income in the year received. Section 408(d).

(a) Distribution will not be deemed to have been received if it is transferred within 60 days after receipt to another IRA and no other transfer has occurred within the year prior to receipt.

(b) Distributions are subject to income tax withholding unless the taxpayer "elects out." Section 3405.

(c) IRA distributions must begin during the taxable year in which the owner reaches age 70½. Section 408(a)(6).

(d) Premature distributions (*i.e.*, those before the taxpayer has attained age 59½, has become permanently disabled, or has died) are subject to a 10 percent penalty tax. Section 408(f)(1).

(3) If an individual borrows from an IRA or uses amounts as security for a loan, the transaction is treated as a distribution and the tax rules for distributions apply.

(4) If the assets of an IRA are used to purchase collectibles, the amount so used will be treated as a distribution and thus included in gross income.

3. Impact Of H.R. 4170 on IRAs

(a) Under section 231 of H.R. 4170, certain non-deductible IRA contributions (up to the non-deductible limit) would not be treated as excess contributions subject to the six percent annual tax.

(1) The non-deductible limit could not exceed \$1,750.

(2) The provision would be effective for tax years beginning after 1983.

B. *Voluntary Employees' Beneficiary Associations*

1. Section 501(a) and section 501(c)(9) of the Code confer tax exempt status to so-called "voluntary employees' beneficiary associations" ("VEBAs").

a. VEBAs are associations organized to provide “life, sick, accident, or other benefits” to their “members . . . and their dependents or designated beneficiaries.”

b. Most commonly, VEBAs are established by employers to pre-fund the cost of benefits paid on a deferred basis to employees.

2. Income Tax Treatment

a. VEBAs are not taxed on amounts received from members to provide permissible benefits and portfolio earnings set aside to pay benefits likewise are not taxed. Section 512(a)(3)(B).

b. Contributions by an employer are currently deductible under section 162 of the Code.

3. May be useful as a financial planning device in regard to the timing of deductions and to avoid certain limitations in regard to eligibility and discrimination on deferred compensation arrangements imposed by the Employee Retirement Income Security Act of 1974 (“ERISA”) and subsequent legislation.

C. *H.R. 10 Or Keogh Plans*

1. An H.R. 10 or Keogh plan allows a self-employed taxpayer to contribute annually the lesser of \$15,000 or 15% of earned income to provide for such individual’s retirement.

a. In 1984, the deductible limit is increased to the lesser of \$30,000 or 25% of earned income.

2. Income Tax Treatment—In General

a. Contributions by the individual are deductible currently.

b. Income earned on such contributions are not currently taxable.

D. *Other “Comparable Investments”?*

1. Corporate Bonds and U.S. Government Obligations

2. Municipal Bonds

3. Industrial Development Bonds (“IDBs”)

4. Tax Shelters such as Oil and Gas and Real Estate