INDIVIDUAL PLANNING WITH LIFE INSURANCE

FIELD GUIDE TO LIFE INSURANCE

TRANSAMERICA®

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The main purpose of a life insurance policy is to provide a death benefit. It is not a short-term savings vehicle nor is it ideal for short-term insurance needs. It is designed to be long term in nature and should be purchased only if you have the financial ability to keep it in force for a substantial period of time.

SAVE, INVEST, PROTECT, RETIRE

There are many important and exciting milestones in life to prepare for; buying your first home, having children, retirement.

It is important to plan for the unexpected as well, however, as life has a way of disrupting our vision for the future. Unexpected and costly repairs, serious illness, or death could be financially draining when unaccounted for. Life insurance can be an effective option to address life's unexpected twists, help enhance your overall financial security, and protect your loved ones or even a business.

± 50%

of all people in the United States are covered by some form of life insurance, but research conducted by LIMRA suggests a needs gap of 41 million consumers who recognize they need life coverage but say they do not have any.[1]

[1] "Facts + Statistics: Life Insurance," Insurance Information Institute, accessed online December 2021

AN EVOLVING FINANCIAL TOOL

- Universal life insurance is flexible
- Life insurance has evolved to provide more than just a death benefit
- It can be used in many facets of individual planning
- Understanding these uses can help provide a better outcome for individuals and families

FIVE REASONS YOU MAY NEED LIFE INSURANCE

The reason people buy life insurance may seem obvious - the death benefit. Beyond the obvious, life insurance has evolved to be a dynamic financial planning tool used for a variety of reasons. From retirement planning to long term care, there are many ways to apply life insurance as part of your overall financial plan. Here are some additional reasons you may need life insurance:

PROTECTION FOR LOVED ONES — THE OBVIOUS

They are your loved ones for reasons only you can express, but the reason you spend a lifetime protecting them is obvious. Life insurance is for the living; it is to ensure that the commitment to the lifestyle you always envisioned for them is realized even if you won't be there with them. To protect them from the financial loss and hardship they could potentially be forced to endure in the event of your untimely death, by helping to fill the income gap and offsetting expenses.

All too often, loved ones are forced to make difficult decisions at an emotionally trying time, when they may be least able to make sound decisions. Life insurance can provide them with alternatives and options and the necessary time to adjust to their new reality, rather than being forced to make tough decisions quickly, such as whether to sell the family home or go back to work.

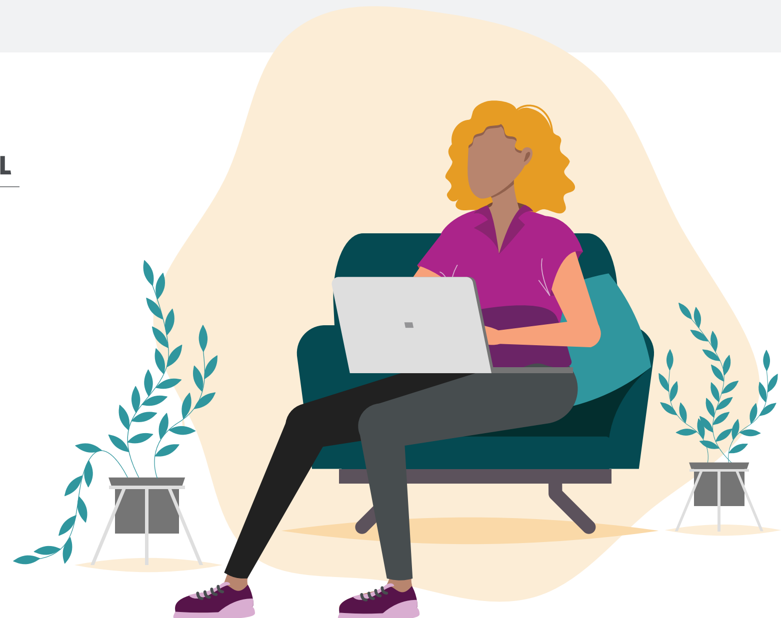
FINANCIAL REASSURANCE

Life insurance can help protect you and your loved ones from the many uncertainties in life, and help you be prepared for just about any eventuality. You'll sleep a little easier at night knowing that no matter what, your family will be well taken care of when you are gone.

LIFE INSURANCE IS A VERSATILE ESTATE PLANNING TOOL

Life insurance can:

- Cover burial expenses
- Provide liquidity to cover taxes
- Bypass probate
- Pay out income-tax free death benefit
- Replace lost income
- Pay off outstanding debts



How Much Life Insurance Do I Need?

Life insurance is essential to ensure your loved ones are protected in the worst of situations. From paying taxes, debts, and outstanding bills, life insurance provides the financial reassurance to ensure you leave a legacy. Knowing the proper amount of life insurance coverage may be difficult depending on your goals.

THINGS TO CONSIDER

There are many factors that can be taken into consideration to determine your coverage needs. Ensuring you have all relevant considerations accounted for is the first step.

- How old are you?
- Are you employed? Is this your family's primary source of income?
- Who do you want to protect?
- Are you married? Do you have children?
- Are there special needs for any of your beneficiaries?
- How long would they require financial support?
- How much do you pay in taxes?
- How much do you earn before taxes?
- At what age are you planning to retire?
- What is the value per year of home responsibilities you manage, such as mowing the lawn, chauffeuring kids, or whatever role your survivors would have to pay someone else to do?
- How much do you receive in employee benefits, such as contributions to retirement savings?
- Do you own a business?
- Are you saving for a child's education?
- How much will your family need for things like clothing, food, and transportation?
- Do you own a home? How much is the mortgage?

This is not an exhaustive list, as everyone's circumstances are unique and personal.

› RETIRE DEBT

Debt and income are both major factors in life insurance needs analysis. Many types of debt such as mortgages and other loans that you and your spouse applied for jointly will become their responsibility upon your death. Other potential scenarios can lead to creditors trying to collect against your estate, which could retire debt but lead to less money being left for your loved ones. Life insurance can be used to create liquidity to pay off outstanding debt.

The average American has **$52,940** worth of debt across mortgage loans, home equity lines of credit, auto loans, credit card debt, student loan debt, and other debts.[2]

› COVER END-OF-LIFE EXPENSES

Funeral costs can vary widely across the country, but typically average nearly **$8,000**.[3] These average costs do not include monuments, markers, or things such as flowers and funeral luncheons. Additional final costs may be relevant as well, such as medical bills, long term care, and other potential end-of-life costs. Including these costs in the life insurance valuation can spare loved ones from additional expense and heartache while they grieve.

48% of surveyed Americans cite covering burial and other final expenses as the major reason to own life insurance.[4]

Given all that must be accounted for, determining the proper amount of life insurance coverage can be difficult. To help simplify arriving at this figure, there are needs analysis calculation methods can be useful.

[2] "The average American debt by type, age, and state," Insider, updated May 25, 2021
[3] "2021 NFDA General Price List Study," National Funeral Directors Association, November 4, 2021
[4] "2021 Insurance Barometer Study," LIMRA, 2021 (Data based on over 3,000 surveyed respondents)

PICKING A NEEDS ANALYSIS METHOD

Once you have outlined all of the relevant factors, calculating a coverage amount is the next step. This is much more involved than it sounds. To complicate things, there is no single universally accepted method to calculate coverage levels. Below are several common life insurance needs analysis methodologies and how they differ.

› MULTIPLE OF INCOME

WHAT IS IT?

A calculation that multiplies your income by a set number of years

Pros:

Simple and easy to calculate

Cons:

May not take into consideration your actual needs arising from family, assets, debts, taxes, inflation, and other aspects unique to your situation and the economy

Hypothetical Example:

$100,000 Annual Income X **10** years = **$1,000,000** of required life insurance
A variation of this method calls to add **$100,000** for every child, primarily for education expenses
$100,000 Annual Income X **10** years = **$1,000,000** + **$200,000** (2 children) = **$1,200,000**

› HUMAN LIFE VALUE

WHAT IS IT?

An income-based method that takes into consideration various personal factors and future earnings

Step 1: Calculate earnings, including expected wage increases, between now and a set point in the future (retirement for example)

Step2: Reduce that figure by expected income taxes and consumption costs for the insured (such as food, clothes, personal transportation, travel)

Step 3: Discount the sum by the expected amount of interest or return expected over the period chosen

Step 4: Add the amount of expected benefits, such as employee benefits, over the period

Pros:

Comprehensive, takes into consideration more factors than the multiple of income method

Cons:

More complicated, takes multiple steps. May not account for funeral expenses, educational expenses, or actual future needs (debts and mortgage for example). Discounting for taxes and rate of return may be too aggressive. The discounting step is optional and may be omitted.

Hypothetical Example:

$100,000 annual income, with **2%** expected annual wage increase, anticipated **4%** simple interest rate over the duration, and retirement in **15** years.

Step 1: Calculate the wages plus **2%** annual increase for **15** years = **$1,763,929**

Step2: Reduce the wages for taxes. Subtract **30%** (**24%** hypothetical federal tax and **6%** hypothetical state tax) from the **$1,763,929** = **$1,234,750**

Step 3: This step is optional. Discount the after-tax wage amount by an expected rate of return.
4% Simple Interest X **15** Years = **60%**.

$1,234,750 reduced by **60%** = **$493,900**

Step 4: Expected benefits over the **15** years are **$50,000**. **$493,900** + **$50,000** = **$543,900**

› CAPITAL NEEDS ANALYSIS

WHAT IS IT?

The capital needs analysis method takes into consideration not just the lost income of the insured but also the capital needs of their beneficiaries, both immediate and future. The capital needs approach takes the following into consideration:

- Income: from both the insured and the surviving spouse
- Liquidity needed at death: including funeral expenses, mortgage, and debt repayment
- Future expenses: including college, retirement, and care expenses of the spouse
- Other assets: value of assets available to help cover the above items

After everything is taken into consideration, there are then two ways to calculate insurance needs.

- **Earnings-Only Approach**
  The survivors will live off only the investment earnings of the policy without cashing in the principal value. To provide a sufficient income stream, the death benefit is usually larger than in the approach below.
- **Liquidation Approach**
  The surviving beneficiary utilizes a portion of the principal as well as the investment earnings. There is more risk with this approach, particularly if the investment earns less than originally predicted. Since principal is used, the proceeds may exhaust at some point.

› DIME METHOD

WHAT IS IT?

DIME stands for Debt, Income, Mortgage, and Education. This simple calculation takes into account four major considerations for determining life insurance need.

Debt and Assets

Income and Insurance

Mortgage and Taxes

Education and Expenses

EXAMPLE

ADD (Items that need to be covered or replaced)

TOTAL DEBT	+ $75,000
TOTAL INCOME	+ $100,000 X **15 Years** Until Retirement
TOTAL MORTGAGE	+ $250,000
TOTAL TAX	+ $30,000
TOTAL EDUCATION	+ $300,000
TOTAL EXPENSE	+ $40,000

SUBTRACT (Items that are liquid to help cover needs)

TOTAL ASSETS	- $12,000
TOTAL INSURANCE	- $150,000
TOTAL RESULT	**$2,033,000 Insurance Need**

Understanding the right amount of life insurance is essential. Taking the time to arrive at the proper amount is worthwhile to ensure adequate coverage. Regardless of the method you elect, using the right tools can make this process easier. Worksheets and fact finders are a great way to make sure everything is taken into consideration. The actual amount of life insurance you need will depend on several factors, which you need to consider carefully.

2.

CASH VALUE ACCUMULATION

As there are innumerable options for asset accumulation — from savings accounts, 401(k), IRAs, and annuities to mutual funds — it is nearly impossible to name them all. Although life insurance is most commonly associated with death, the right type of policy may complement other accumulation strategies. For individuals who have already maxed out other retirement account types or are not eligible to contribute to a Roth IRA due to income limitations, but are looking for additional ways to save, a permanent life insurance policy might be the answer.

Whole life, universal, and variable life policies systematically build up cash value as policy owners make premium payments into the policy, which can be accessed to supplement retirement income, through loans and withdrawals.*

Moreover, it is important to understand the rules surrounding life insurance. These are covered in great detail in the Rules of the Road section at the end of the document. In general, distributions from the cash value are generally a tax-free return of basis first, then gains, mitigating tax burden throughout retirement. Additionally, some permanent insurance policies are eligible for dividend payments. Though not guaranteed, when paid, these dividends can be directed to enhance a policy's cash value. Furthermore, loans taken to cover costs in retirement are generally permissible.

Only **27%** of surveyed workers "feel very confident" they will be able to retire comfortably.[5]

LIFE INSURANCE AS AN ASSET CLASS

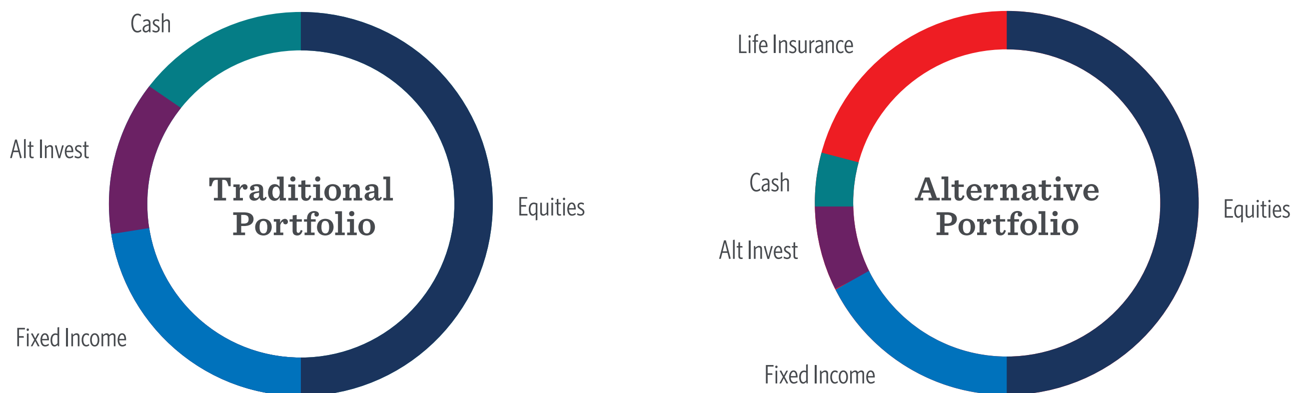
Your circumstances are personal and unique to you. Perhaps you have maxed out your allowable contributions into your retirement accounts and have a need for insurance? Maybe you are looking for alternative products to complement and diversify your financial portfolio? In any case, the strategic use of life insurance as part of your overall financial strategy may help you achieve your goals and objectives.

[5] "Retirement Security: A Compendium of Findings About U.S. Workers," 20th annual Transamerica Center for Retirement Studies®, December 2020

* Loans, withdrawals, and death benefit accelerations will reduce the policy value and the death benefit and may increase lapse risk. Policy loans are tax-free provided the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

› INVESTMENT MANAGEMENT

A degree of uncertainty always exists around future tax law, the global financial marketplace, and the general state of the economy. While life insurance is traditionally associated with postmortem expense management and income replacement strategies, permanent cash value life insurance can be leveraged as part of a comprehensive overall financial strategy to potentially address some of these uncertainties. The potential for cash value growth relative to a low-risk profile makes it a potential accumulation and preservation alternative. Life insurance may be excluded when taking a financial inventory. Even though it may be an asset someone owns, it may be excluded in the thought of the "traditional portfolio." To get a better understanding of someone's financial picture, it should not be excluded, as it can be an important element for supplemental income or cash value accumulation.



ADVANTAGES OF PERMANENT LIFE INSURANCE AS AN ASSET CLASS

› PREDICTABLE

Permanent life insurance policies may offer a guaranteed* rate of return, a guaranteed death benefit, and a level premium over the life of the policy. The predictable nature of these key financial elements makes it easier to create a plan to address projected future needs. The cash value component of indexed universal life policies can be attributed to a specified interest rate or credited with excess index interest based in part on a weighted average of changes to a financial index such as the S&P 500®, with preestablished floors and ceilings. Having a defined interest rate or predetermined floors and ceilings aids in the process of management, coordination, and diversification of an overall financial plan.

› NON-CORRELATED

Stock and bond markets are unique and markedly different in many ways, yet they share one common and substantial trait: volatility. Additionally, securities in general are highly correlated, with returns that tend to move up and down with similar trajectories. Permanent cash value life insurance may provide a hedge against market volatility as well as significant global economic events that can adversely affect the financial markets. The cash accumulation component of a life policy bears a nontraditional risk profile that reacts differently than the stock and bond markets to prevailing political, economic, and financial market conditions. By this virtue, incorporating life insurance in conjuction with an investment portfolio allows an investor to manage risk and mitigate volatility. It is important to note that this attribute is only for policies that are not invested or linked to a market index. Those policies are market based and would be correlated.

* Any guarantees are based on the claims-paying ability of the issuing company.
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› TAX EFFICIENT

Investments in a taxable brokerage account often generate a tax burden as the portfolio grows, creating tax drag and reducing the return and total value of the portfolio. But the cash value component of a permanent life insurance policy grows tax-deferred, which permits the cash value to compound and accumulate. Moreover, distributions from the cash value non-Modified Endowment Contract (MEC) policy are generally treated for tax purposes as first-in, first-out (FIFO), which means that a policyholder may take distributions consisting of non-MEC tax-free return of their premium, minimizing taxable income in a given year. Loans also may be available from cash value policies which are generally received tax-free. Finally, life insurance death benefits are generally received free of federal income tax.

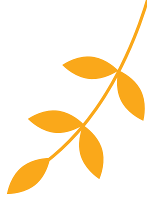
› HEDGE AGAINST SEQUENCE OF RETURNS RISK

Timing is everything in retirement. Sequence of returns risk is a phenomenon in which an investor receives lower returns during the distribution phase of retirement. Specifically, negative returns in the early years of retirement leave a retiree vulnerable to running out of money. If the loss is significant enough, for example, it may not be possible for the portfolio to recover. A potential solution is to reduce or even avoid taking distributions in a declining market, but this may not be practical or even possible. An alternate potential solution is a policy loan using the cash value of a life insurance policy as collateral. The advantage to this strategy is reducing the burden on the overall portfolio. Even though sequence of returns risk still exists, loans from a life insurance policy may act as a buffer to avoid withdrawals in declining markets. This can cause a reduction in policy value and death benefit.

› LIFE SETTLEMENTS

A life settlement is an alternative method of accessing the value of a life insurance policy through an outright sale and assignment to an alternate party. Upon death, the contract owner (life settlement company) will receive the death benefit.

Typically, a settlement provider purchases the policy from the policy owner in cash for a sum that is greater than the policy's cash value, but less than the policy's face value. The higher cash value sum received from the settlement provider can be used to cover expenditures incurred for emergencies, medical care, or any other costs.



BREAKING DOWN THE DIFFERENCES BETWEEN TRADITIONAL SECURITIES AND CASH VALUE LIFE INSURANCE

	During Life		At Death
TAXABLE ACCOUNT			
Subject to market volatility	Subject to annual income and capital gains taxes	ACCESS: Taxable withdrawals	Step-up in basis, then subject to annual taxation
CASH VALUE LIFE INSURANCE			
Predictable returns	Tax-deferred	ACCESS: FIFO withdrawals, tax-free loans*, life settlements	Federal income tax-free death benefit

It is important to note that the comparison above is only to illustrate the difference in federal tax treatment of life insurance versus a taxable account. It must also be noted that there are vast differences between life insurance and other financial assets. These would include the features and death benefits associated with a life policy. The fees and costs associated with life insurance and other types of financial accounts are going to vary and should be a consideration beyond the scope of this tax comparison.

UNDERSTANDING THE IMPACT OF POTENTIAL PERFORMANCE OVER TIME

› RULE OF 72: HOW FAST DOES IT REALLY DOUBLE?

Predicting potential investment performance is very difficult. Add in the complexity of how varying rates of return impact an investment over time and it can get confusing fast. Understanding performance and potential rates of return are important elements in evaluating investments, but other factors also play a role. The rule of 72 is one method of understanding the impact of potential investment performance over time without mind-numbing math.

WHAT IS IT?

The rule of 72 is a formula that lets you get a close approximation of how long it would take for an investment to double at a specified rate of return.

HOW DOES IT WORK?

Divide 72 by the potential annual rate of return. This gives you the approximate number of years it will likely take for your investment to double.

72 ÷ 2 = 36 At 2% money nearly doubles every 36 years		72 ÷ 4 = 18 At 4% money nearly doubles every 18 years		72 ÷ 6 = 12 At 6% money nearly doubles every 12 years	
YEARS	AMOUNT	YEARS	AMOUNT	YEARS	AMOUNT
Initial Amount	$10,000	Initial Amount	$10,000	Initial Amount	$10,000
36	$19,999	18	$20,258	12	$20,122
70	$39,996	36	$39,996	24	$40,489
		53	$79,941	36	$81,473
				48	$163,939

* If a policy is fully surrendered, allowed to lapse, or exchanged for another life insurance, annuity, or long term care policy, however, loans are taxable to the extent that the cash value exceeds the owner's tax basis in the contract.

› TAXES MATTER

One major limitation of the rule of **72** is that it does not take into consideration the impact that taxes have on an accumulation strategy. To calculate the impact of taxes, first estimate the after tax rate of return by multiplying the rate of return by the after-tax rate. Then divide **72** by the after-tax rate of return.

Hypothetical Example:

Assuming a **40%** tax rate, the after tax rate is
1 - 0.40 = 0.60

Take the rate of return **(4%)** and multiply it by the after tax rate: **4% x 0.60 = 2.4%** rate of return after taxes

Divide **72** by the rate of return after taxes: **72 ÷ 2.4 = 30**

At **4%** rate of return and **40%** tax rate, money will double approximately every **30** years.

› INFLATION DEFLATES VALUE

Inflation should not be overlooked over such a long period of time. If the growth rate does not exceed inflation, your purchasing power is actually less than what you started with. You can also factor in inflation using the rule of 72. For it to work, the rate of inflation must be less than the after-tax rate of return. Here is how the math works to estimate the amount of time to double an investment at a specified rate of return adjusted for inflation:

Subtract the rate of inflation from the rate of return after taxes. Divide that figure into **72.**

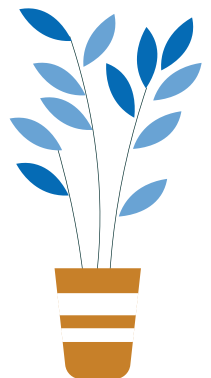
Hypothetical Example:

2.4 (rate of return after taxes) – **2%** (inflation) =
0.40% divided into **72 = 180** Years

TAX-FREE ACCOUNT		TAXABLE ACCOUNT	
GROWTH RATE	RULE OF 72: years to double	RULE OF 72: years to double tax rate of 25% and 40%	ADJUSTED FOR 2% INFLATION: years to double
4%	18	24 and 30	72 and 180
6%	12	16 and 20	29 and 45
8%	9	12 and 15	18 and 26
10%	7	10 and 12	13 and 18

Both inflation and taxes can play a significant role on accumulation over time. Being mindful of these factors can help mitigate them. Here are a couple of factors to consider:

- **Tax Diversification**
  Investing assets into accounts with different tax characteristics can help. In addition to currently taxable investments, adding in tax-deferred assets and tax-free assets can help control the impact of taxes.
- **Investment Selection**
  Some investments may never beat inflation due to lackluster performance. Selecting investments that have the potential to outperform inflation can help mitigate exposure to inflation.



COMPARISON OF ACCOUNT TYPES		
CURRENTLY TAXABLE	**TAX-DEFERRED**	**TAX-FREE**
Created with after-tax proceeds, taxable in the current year or upon sale	May be funded with both pre- and after-tax proceeds. Tax-deferred while invested, taxable upon withdrawal.	Created with after-tax proceeds, tax-free when withdrawn
• Stocks • Mutual Funds • Bonds • Real Estate • CDs and Money Market	• Qualified Retirement Plans • Annuities • IRAs (traditional, SEP, SIMPLE) • Life Insurance Cash Values (withdrawal)	• Municipal Bonds • Roth IRAs and 401(k)s • 529 Plans • Life Insurance (loans and death benefits)
Pros • Liquidity • No contribution limits • Unlimited investment options • Potential capital gains treatment • Step-up in basis at death (for capital gains)	**Pros** • May provide a tax deduction • More control over taxation through timing withdrawals • Ability to switch investments without tax • Tax-deferred growth	**Pros** • Proceeds are generally free of income tax • Amounts paid to heirs are free of income tax • Tax-free growth
Cons • No tax deduction • Varying tax treatments depending on asset and holding period	**Cons** • Distributions are generally taxed as ordinary income instead of capital gains. • May have limited liquidity prior to age 59½ • Investments may be limited by platform.	**Cons** • Contribution limits and rules apply • No tax deduction

Note that the table above is meant to categorize different types of accounts by tax treatment. There are other important differences that must be addressed, such as fees and costs, that are beyond the scope of this table.

› TAKE INVENTORY

Get a complete view

- Worksheets, fact finders, and software can help

Determine where the bulk of assets are held

- Look at both total amount and the percentage

Develop a strategy and identify deficiencies

CURRENTLY TAXABLE	TAX-DEFERRED	TAX-FREE
Savings account and CDs	Traditional IRAs and annuities	Roth IRA/401(k) and Municipal Bonds
$	$	$
Brokerage account	Retirement plans (e.g., 401(k), 403(b))	Life Insurance Loans and Death Benefits
$	$	$
Mutual funds	Life Insurance Cash Values (withdrawals)	College savings accounts (e.g., 529)
$	$	$
%	%	%
Total	Total	Total
$	$	$

HOW POLICY ACCUMULATION MAY HELP WITH PLANNING

› USE IT AS PART OF AN EMERGENCY FUND

Conventional financial planning doctrine advocates for an emergency fund to cover three to six months of living expenses should you lose your job or you are unable to work, though more or less may be necessary depending on your personal circumstances. An emergency fund may alleviate the need to borrow money by providing a financial buffer in a time of need. Many types of permanent life insurance policies such as whole life or various types of universal life build up cash value that can be used as a source of funds in an emergency. Furthermore, loans are generally permissible and unlike a typical loan, you do not have to pay back a loan against the cash value of a life insurance policy within a set period of time.

Less than half of Americans **(49%)** have at least three months of savings in an emergency fund, and **25%** have no emergency savings whatsoever.[6]

› PAY FOR COLLEGE

Of the many ways to save and pay for college, life insurance should not be overlooked as a complementing or alternative strategy. Many types of permanent life insurance policies, such as whole life or various types of universal life, build up cash value that can be used for any purpose, such as paying for college. Policy loans can be used to pay for college expenses, room and board, and other needs as well. Another benefit of using permanent life insurance to save and pay for college is that **the cash value is generally excluded from certain financial aid calculations.**[7] At the same time, it continues to serve the primary purpose of paying a death benefit if the individual funding the college expenses passes away.

The average cost of attendance for a student living on campus at a public four-year in-state institution is **$101,948** over four years. Average traditional private university students spend a total of **$212,868** over four years.[8]

Life insurance cash values can be used for any number of purposes. The cash value component of life insurance should not be overlooked as it can complement various planning objectives. After accumulation has occurred, the next thought naturally turns to distributing the proceeds.

[6] "More than half of Americans couldn't cover three months of expenses with an emergency fund," Bankrate, July 21, 2021
[7] "Assets You Don't Need to Report on the FAFSA," The College Solution, accessed online December 2021
[8] "Average Cost of College & Tuition," educationdata.org, accessed April 4, 2022

SUPPLEMENTAL RETIREMENT INCOME

Life insurance cash values should not be overlooked as a potential source for supplementing retirement income. As one enters retirement, the amount of life insurance coverage needed may be lower and cash value that has accumulated in a life insurance policy may help ensure adequate income in retirement. Retirement income planning is something that people generally want help with and may not understand completely. Consider the following:

INDIVIDUALS NEED HELP WITH RETIREMENT INCOME PLANNING

67%

Do not have a formal, comprehensive, written retirement plan[9]

32%

Understand the 4% rule[9]

7 IN 10

Underestimate the life expectancy of a 65-year-old man, suggesting that many do not realize how long their assets have to last[9]

INDIVIDUALS WANT HELP WITH RETIREMENT INCOME PLANNING

71%

of consumers age 55-75 see high value in having guaranteed lifetime income to supplement Social Security[10]

60%

of consumers are looking for both protection and growth at the same time[10]

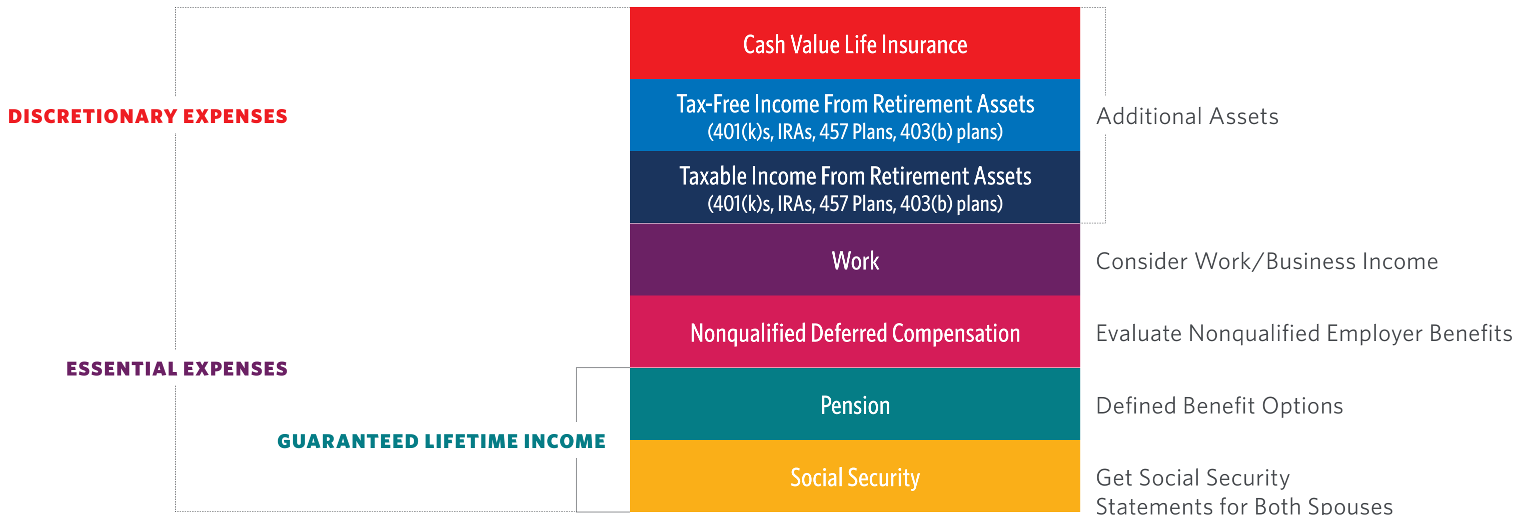
79%

think financial advisors should present 2 to 3 options for how to get income from investments[10]

[9] "Retirement Income Literacy Survey," The American College of Financial Services, 2020 (Data based on over 1,500 surveyed respondents)
[10] 6th Annual Guaranteed Lifetime Income Study,' Greenwald & Associates and CANNEX, 2020

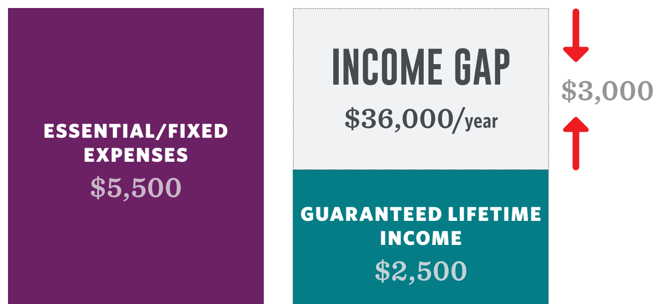
What role might life insurance play in retirement income planning? One method is to match up retirement expenses with different types of retirement assets. This example shows how matching life insurance cash value with discretionary expenses can help meet these expenses.

› MATCHING ESSENTIAL EXPENSES WITH GUARANTEED INCOME



Many individuals may have a gap between their expenses and sources of guaranteed income. When this occurs life insurance cash values may be considered to help fill this gap. Even though it may be useful to help fill the gap, life insurance is not the only asset that can potentially fill the gap.

› CLOSING THE GAP



- If a gap exists, accumulations in cash value life insurance can help close it
- Loans are not taxable, so long as the policy remains in-force. If the policy lapses, loans in excess of basis will become taxable.
- Distributions from non-MEC policies are cost basis first

Life insurance cash values when accessed through loans do not add to taxable income*. This can be useful in retirement income planning.

› INSULATION AGAINST POTENTIAL TAX INCREASES

Retirement income must address taxation of retirement benefits. Even low marginal tax rates can impact drawdown rates and purchasing power. One potential use of life insurance cash value is to provide a source of supplemental retirement income for someone with a high tax rate. If income is needed and the individual is in a high tax bracket, a policy loan may provide a tax-free source of proceeds. From an income tax perspective, a policy loan would not increase taxes, where a withdrawal from a retirement account, such as an IRA, would.

THE IMPACT OF LIFE INSURANCE

› LIFE INSURANCE CAN HELP SUPPLEMENT A RETIREMENT INCOME PLAN:

- Helps supplement accumulation through potential tax-deferred cash value build up
- Provides protection against mortality for loved ones during retirement
- Allows the ability to access proceeds through loans without paying taxes

* So long as the policy remains in force and is not a MEC.

LONG TERM CARE

Long term care (LTC) costs can be expensive. One application for life insurance is the use of riders to help cover long term expenses. Before we get into those details, let's look at long term care in general.

Long term care is one of the most costly retiree expenses. Long term care services help people improve or maintain their quality of life, and can include assistance from other people and special equipment or assistive devices.

Typically, the need for long term care increases as one gets older, although it varies widely. While 30% of people age 65 and over will never need care, 70% will. And 20% of those who do require care will need five years or more.[11] It's hard to guess how advancing age will affect everyone. Planning can help people work toward a comprehensive financial strategy.

More than two-thirds of people over age 65 can expect to use some form of long term care.[11]

WHO WILL HELP WITH LTC?

One recent study[12] highlighted mixed thoughts among American households regarding long term care planning:

47%
of surveyed adults expect their spouse or partner to help with LTC needs

26%
expect their children to assume the role

69%
have not discussed the issue with their family

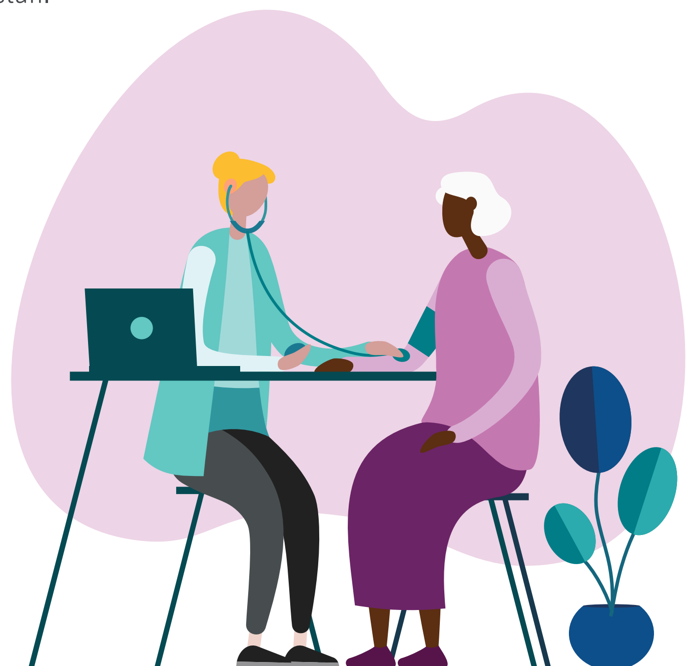
[11] "How Much Care Will You Need," LongTermCare.gov, accessed April 11, 2022
[12] Long Term Care Needs Not Included in Future Financial Plans for Many, Northwestern Mutual, March 2018 (Data based on surveyed respondents)

Most people (who aren't on Medicaid) pay for long term care with retirement income, savings, and investments. These include Social Security, pensions, 401(k) plans, IRAs, stocks, bond, and annuities. Investments are particularly important, since savings alone typically won't keep up with annual cost increases.

Long term care providers fall into two broad categories — informal care and formal care. Informal care is commonly provided by spouses, children, friends, and other loved ones in the earlier stages of disability. Formal care is paid care provided in the home or in a community. Recently, more formal caregiving options have become available, and there are solutions that may meet most people's needs.

› KEY TERMS

- **Activities of Daily Living (ADLs)**, as defined by the U.S. Department of Health and Human Services, are the basic tasks of everyday life, such as eating, bathing, dressing, and transferring.
- **Respite care** is an arrangement that offers an informal caregiver the opportunity for a break. It is a temporary option that can be offered in the home or at a facility.
- **Home healthcare** is more specialized and is often provided by nurses, doctors, and therapists. It is typically provided on an ad hoc basis and will not involve ongoing assistance with ADLs.
- **Intermediate care** is rehabilitative in nature and is provided by licensed nurses and technicians with required supervision by a physician.
- **Custodial care** helps people with ADLs, and is usually needed on a 24-hour basis, which makes the ultimate cost higher than many other kinds of care. It's generally not covered by Medicare.
- **Continuing care retirement communities** are a combination of independent living communities, assisted living facilities, and nursing homes.
- **Assisted living facilities** are licensed housing alternatives for those who may need help with specific ADLs, but don't need the advanced medical care available in nursing homes.
- **Skilled nursing/skilled care** is a type of high-level care such as nursing, physical therapy, and speech therapy provided by licensed practitioners and rehabilitation staff.
- **Nursing homes** generally provide the highest level of care. They are licensed facilities that offer skilled nursing care to chronically ill residents who are not able to take care of daily living needs on their own.



For some high net worth individuals, self-insuring against a long term event is possible. For others, who don't have the necessary resources for care, Medicaid eligibility is an option. But for those who fall between these groups, a traditional qualified long term care policy, a life insurance policy with additional riders, or an annuity policy with additional riders*, may be an option to help you and your family sustain the quality of life you deserve. Because most individual policies require medical underwriting, finding a policy at a reasonable age (50s or 60s) and with health on your side is important. You may not qualify if you are in poor health or already receiving long term care services.

There is no one-size-fits-all policy and understanding what is and isn't covered is essential to pick the right policy for your needs. Transamerica has compiled this checklist to help you and your financial professional compare and contrast the different policy options available to you.

Hybrid Life Insurance

WHAT ARE THE PAYMENT MODES?

___ Single Pay ___ 5-Pay ___ 7-Pay ___ 10-Pay ___ Annual

HOW MUCH ARE PREMIUMS? ______________________

WHAT TYPE OF BENEFIT DOES IT PROVIDE?

___ Accelerated Death Benefit Rider ___ Standalone LTC Rider

Benefit Eligibility: ______________________

Rider benefit period: ______________________

WHAT IS THE LTC RIDER'S SPECIFIED AMOUNTS?

Minimum: ____________ Maximum: ____________

WHAT IS THE ELIMINATION PERIOD? ______________________

WHAT IS THE MONTHLY OR LUMP SUM BENEFIT AMOUNT?

____

* Riders and benefits have specific limitations, may incur additional costs, and may not be available in all jurisdictions. For complete details, including charges, terms, and conditions of each rider and exact coverage provided, please contact the sales desk.

ARE ALZHEIMER'S DISEASE AND OTHER DEMENTIA, OR ORGANIC MENTAL AND NERVOUS DISORDERS COVERED?

- ☐ Yes
- ☐ No

DOES THE POLICY OFFER INTERNATIONAL COVERAGE FOR LTC?

- ☐ Yes
- ☐ No

DOES THE POLICY COVER INFORMAL CARE FOR LTC?

- ☐ Yes
- ☐ No

DOES THIS POLICY REQUIRE:

- ☐ An assessment of activities of daily living (ADLs)? (Usually needing help with two or more of the six ADLs)
- ☐ An assessment of cognitive impairment?
- ☐ Physician certification of need?
- ☐ A prior hospital stay for nursing home care?
- ☐ Home healthcare?
- ☐ A prior nursing home stay for home healthcare?
- ☐ Other?

IS THE POLICY GUARANTEED RENEWABLE?

- ☐ Yes
- ☐ No

WHAT IS THE AGE RANGE FOR ENROLLMENT? ______________________

IS THERE A WAIVER-OF-PREMIUM PROVISION?

For nursing home care	
For home healthcare	
For assisted living care	

HOW LONG MUST I BE CONFINED BEFORE PREMIUMS ARE WAIVED? ______________________

DOES THE POLICY HAVE A NONFORFEITURE BENEFIT? ______________________

DOES THE POLICY OFFER AN INFLATION ADJUSTMENT FEATURE? IF SO, WHAT IS THE RATE OF INCREASE? HOW OFTEN IS IT APPLIED? FOR HOW LONG? IS THERE AN ADDITIONAL COST?

____

WHAT DOES THE POLICY COST?

With inflation feature: $ Without inflation feature: $	Per year
With inflation feature: $ Without inflation feature: $	Per month

LEGACY AND ESTATE PLANNING

Estates that are large enough may be subject to a hefty federal estate tax bill with a top rate of 40%.[13] Additionally, several states assess an estate tax against certain estate sizes as well, and a few even assess an inheritance tax, imposing a tax bill on your beneficiaries based on the amount you leave them. While spouses are usually exempt, changes in tax law at both the state and federal level, over time, should always be considered. Future legislation could reduce or even increase the estate and inheritance tax burden. In either case, life insurance can be used to generate sufficient liquidity to cover these additional costs. Furthermore, life insurance can also be used to create an immediate estate for your beneficiaries upon your death.

Life insurance passes to your heirs via beneficiary designation, bypassing the time, cost, headache, and public nature of the probate process. Moreover, death benefits generally pass to your heirs income-tax free. Ultimately, leveraged alongside the protections of a will or trust, life insurance can ensure that a lump-sum death benefit will be available to effectively transfer wealth to your heirs.

There are numerous applications for life insurance that would be impossible to cover in this document. Here are several notable ways life insurance is used in estate planning applications.

LIFE INSURANCE AND TRUSTS

When you purchase life insurance, you name at least one beneficiary who will receive the death benefit proceeds upon your death. If you set up a life insurance trust, the trust is generally the owner and beneficiary. At your death, the trust receives the death benefit proceeds and the trustee distributes the proceeds to your beneficiaries in accordance with the wishes you outlined in the trust when it was established.

[13] "Instructions for Form 706 (09/2021)," irs.gov, accessed online December 2021

› TRUST TYPES

Revocable living trusts

A revocable trust is a fluid document that can be amended. During life, assets can be added or removed, terms and conditions can be modified, beneficiary designations can be changed or revised, and as the title conveys, the trust can even be revoked should the grantor's goals and objectives change. Furthermore, revocable trust taxation flows down to the grantor, so there is no need to file a separate income tax return.

Irrevocable trusts

An irrevocable trust is a trust that with few exceptions, cannot be modified, amended, or revoked once it has been created. An irrevocable trust is a separate tax-paying entity from the grantor; therefore, the trustee must file an annual income tax return.

› ADVANTAGES OF LIFE INSURANCE INSIDE TRUSTS

Control

There are several potential benefits to having a life insurance policy owned by a trust, including control over how the policy proceeds are distributed to the beneficiaries. If the death benefit proceeds of the policy are distributed outright to the beneficiaries, for example, there will be no restrictions on how the proceeds are utilized. An irrevocable trust can ensure that the proceeds of the policy are used appropriately and persist with a degree of longevity.

Flexibility with revocable living trusts

A major benefit of having a policy owned by a revocable trust is flexibility. A revocable trust is a fluid document that can be amended. Assets can be added or removed, terms and conditions can be modified, beneficiary designations can be changed or revised, and as the title conveys, the trust can even be revoked should the grantor's goals and objectives change. Revocable trust taxation flows down to the grantor, so there is no need to file a separate income tax return. Assets included in a revocable living trust pass to beneficiaries outside of probate, avoiding the time, cost, and public nature of the probate process. If the grantor is well under the prevailing estate tax exemption amounts, a revocable living trust can be a powerful estate planning tool.

Estate tax mitigation with irrevocable trusts

Generally, the value of a life insurance policy death benefit, frequently the largest asset includable in an individual's gross estate, is included in the calculation of the estate tax. The Tax Cuts and Jobs Act of 2017 essentially doubled the estate tax exclusion, that is to say, how much of the estate is excluded from taxation to **$11,180,000** beginning in 2018, indexed for inflation (**$12,060,000** for 2022).[14] This amount will sunset after 2025, reverting back to $5,490,000 if it is not made permanent or if the law is not modified in future legislative sessions. Future exclusion amounts could be higher or lower, and with a current top estate tax rate of 40%[15], this could mean a hefty estate tax bill for some estates that can erode the overall value. Therefore, it is important to understand the attributes that determine when a life insurance death benefit is included in the gross estate for estate tax purposes.

A properly structured irrevocable trust precludes assets, including life insurance death benefit proceeds, from being includable in the gross estate. An irrevocable life insurance trust (ILIT) is a common class of irrevocable trust that removes the life insurance death benefit from inclusion in the gross estate, preserving the total death benefit value left to the heirs.

Estate inclusion

- Policy death benefit proceeds are includable in the gross estate of an insured who transferred ownership of the policy as part of a gift within three years of death (three-year lookback rule)[15]

- Policy death benefit proceeds are includable in the gross estate of an insured if he or she maintained any incidents of ownership (e.g., ability to change or modify a policy in any manner)[15]

- Policy death benefit proceeds are includable in the gross estate of an insured if they are made payable to the executor, or for the benefit of the insured's estate (regardless of who owned the contract or paid the premiums)[16]

Creditor protection

Creditor protection can be another valuable benefit of having a life insurance policy inside a trust. While most states provide some creditor protection of varying degrees for policy owners and beneficiaries, the protections in certain cases are not without limits and are based on the how respective state laws apply to a particular set of circumstances. An irrevocable trust may provide an additional layer of protection to ensure that a creditor cannot satisfy a judgment against the grantor or beneficiary for the cash value or the death benefit proceeds of the policy. It should be noted, however, that an irrevocable trust set up for the purposes of defrauding a creditor may eliminate the protections of an irrevocable trust.

Probate avoidance

Life insurance death benefit proceeds pass via beneficiary designation, and therefore transfer to beneficiaries outside of probate. Certain circumstances can subject an otherwise non-probate asset to the time, cost, headache, and public nature of the probate process. The most common causes for this are outdated or incomplete beneficiary designations and the absence of contingent beneficiaries. Additionally, a life insurance trust can be crafted to include multi-generational distribution planning, which can be more specific and comprehensive than typical per-stirpes beneficiary designations.

[14] Estate Tax," IRS.gov, accessed April 11, 2022
[15] "Instructions for Form 706 (09/2021)," irs.gov, accessed online December 2021
[16] §2042 (1)(2) and §2035(a)(1)(2)

Guardianship avoidance

Significant inheritances cannot be left to a minor. In the absence of a selected guardian, the courts will get involved, delaying access, incurring costs, and may ultimately designate a guardian who would not have been chosen by the policyholder when they were alive. A life insurance trust avoids these potential complications, as the trust will be receiving the death benefit proceeds which can be administered for the benefit of the minor without court intervention.

Preserve government benefits

A properly structured life insurance trust can provide for the health, education, maintenance, and support (HEMS provisions) of a special needs individual while preserving the ability of the individual to qualify for government benefit programs such as Medicaid and Supplemental Security Income (SSI) from the Social Security Administration.

CHARITABLE PLANNING

Life insurance can transfer an “amplified” gift to your favorite charity when you make the charity the beneficiary. A relatively small amount in the total value of premiums paid in relation to the final value transferred to the charity, can translate into an extremely large and meaningful gift, as compared to what the charity might receive through an otherwise, non-life insurance gift. Additionally, the amount the charity receives is certain, as the death benefit is generally not subject to federal or state taxes, estate settlement and administrative costs, or any other expenses. Other types of gifts such as real estate or securities are subject to potentially wide fluctuations in value. Finally, life insurance passes via contract law, bypassing the time, cost, headache, and public nature of the probate process, so the charity gets to start putting your gift to work right away.

SUMMARY

Life insurance can be used in a myriad of different planning scenarios. Understanding its potential uses can help determine if it is appropriate in a given scenario. As the use of life insurance expands beyond the typical death benefit, it is important to understand the basic rules associated with its use. The remainder of the document will overview some general rules associated with life insurance.

THINGS YOU SHOULD KNOW

› STRUCTURE OF A LIFE INSURANCE CONTRACT

OWNER

Pays premiums and can make changes to the policy, such as changing beneficiaries. The owner is also the responsible part for taxes.

INSURED

May not be the same person as the owner. Insured's death triggers death benefits.

BENEFICIARIES

Receive death proceeds

Life insurance policies have three main components: the ***owner(s)***, the ***insured***, and the ***beneficiary*** or ***beneficiaries***. Additionally, there are two parties to a life insurance contract: the insurance company and the contract owner. The applicant is typically, but not necessarily, the owner and the person on whose life the contract is written and is referred to as the insured. The person or entity who takes out insurance on a person's life is referred to as the applicant or owner. The person whose life is insured is not a party to the contract unless he or she is also an owner of the contract. Additionally, two or more persons or entities may jointly apply for insurance on another person's life. It is also possible for a person or entity to own a policy that insures more than one life, as in the case of a first-to-die or last-to-die policy.

A beneficiary should be chosen to receive the death benefit proceeds upon the death of the insured. While the beneficiaries have a right to these proceeds at death, this right does not make them a party to the contract, nor do they have any incidents of ownership, and they need not know of the contact. The beneficiaries can be assigned certain rights that are enforceable against the insurance company, such as irrevocability, but the rights are only acquired through an agreement between the policy owner and the insurance company.

Finally, it is possible for an owner to transfer certain rights or interests in the policy to another person or entity, called an *assignee.* A common example of this is called a *collateral assignment* in which an owner assigns rights to a certain amount of the death proceeds to secure a loan. If the collateral assignment is standing at death, the assignee will inform the insurance company of the outstanding debt remaining and collect on the amount, and any residual death benefit proceeds will then be paid to the beneficiary or beneficiaries. The owner can also transfer all ownership rights, benefits, and liabilities to another person or entity entirely, which is called an *absolute assignment.* Common reasons to execute an absolute assignment are for purposes of securing a loan or as part of a gifting strategy.

› USING LIFE INSURANCE FOR INCOME

Life insurance policy cash values can be accessed to meet a specific financial obligation or as a means to supplement retirement income through withdrawals from or loans against the accrued cash value. Not all types of life insurance policies can provide a source of supplemental retirement income. Whole life and universal insurance policies, however, build up cash value of varying degrees as policy owners make premium payments over time into the policy. Additionally, some permanent insurance policies are eligible for dividend payments. Though not guaranteed, when paid, these dividends can be directed to enhance a policy's cash value. Interest earned on the cash value grows tax deferred and withdrawals are generally tax-free to the extent of the premiums paid into the policy, though exceptions discussed in the taxation section apply.

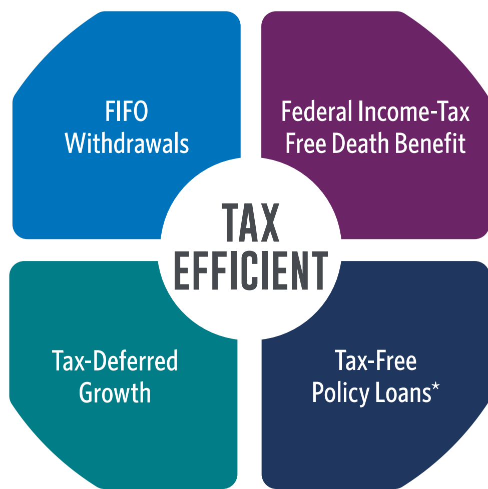
Loans from the policy cash value can also be taken to meet current and future financial obligations and other needs or desires. Loans are essentially an advance from the policy's cash value. Interest accrues against the amount borrowed and there is no set time frame to pay the loan back. It should be noted, however, that the amount of the loan, plus any unpaid interest will be deducted from any values payable under the policy, including the death benefit, reducing the amount the beneficiaries ultimately receive.

Life settlements are an alternative method of accessing the value of a life insurance policy through an outright sale and assignment to an alternate party. A settlement provider generally purchases the policy from the policy owner in cash for a sum that is greater than the policy's cash value, but less than the face value, which can then be used to cover expenditures and other costs.

TAXATION OF LIFE INSURANCE

Life insurance is most commonly associated with end-of-life expenses and wage replacement, so it probably isn't what most people think about when tax season comes around. Yet properly utilized, life insurance can play a role in mitigating overall tax burden.

› INCOME TAX TREATMENT OF DEATH PROCEEDS



Lump-sum death benefit proceeds paid to beneficiaries are generally free of federal income tax, with a few exceptions. One such exception applies to *death benefit settlement options* in which the beneficiary elects for the death benefit proceeds to be distributed as a series of payments and include an element of interest earned after the death of the insured. However, the portion of the settlement option payment that represents the principal (the policy face amount) is received tax-free. The portion representing the principal is calculated by prorating the face amount over the designated settlement option period. Any amount of payment that exceeds the principal is included in taxable income.

Another exception occurs under the *transfer-for-value* rule, which stipulates that a policy that is transferred from one owner to another for valuable consideration of any form, loses the tax-free death benefit element. Under the transfer-for-value exclusion, the beneficiary(ies) recover the premium amounts the transferee paid into the policy tax-free, and the entire value in excess of these premium payments are considered taxable income. In other words, the portion of the death proceeds equal to the consideration paid to acquire the policy or interest in the contract, plus all future premiums paid by the transferee are received income-tax free, but the remaining death proceeds are taxed as ordinary income.[17] There are also exceptions to this exception, however. Finally, an exception applies to a tax-free death benefit when a policy *fails to qualify as life insurance under tax law.*

Policy transfers that are not impacted by the transfer for value rule include[17]:

- The transferee is the insured
- Transfers to a partner of the insured
- The transferee is a partnership in which the insured is a partner
- Transfers to a corporation in which the insured is an officer or shareholder
- Transfers in which the transferee's tax basis is determined by reference to its basis to the transferor

A policy qualifies as life insurance for income tax purposes under IRC section 7702 if it satisfies one of two tests: the *cash value accumulation test* or the *guideline premium and corridor test.* The cash value accumulation test typically applies to traditional cash value policies such as whole life contracts. Under this test, the cash value cannot exceed the net single premium that would be necessary to fully fund the policy's death benefit. The guideline premium and corridor method is a bifurcated test, where policies are designed to meet both the guideline premium and the corridor requirement and are typically applied to universal and similar types of policies. The guideline premium requirement restricts the total premium amount paid into the policy at any given time, and it based on each respective life insurance company's expense and mortality history and return assumptions up to the predetermined IRS limits. The policy meets the death benefit corridor requirement if the policy's death benefit exceeds a designated multiple of the cash value at all times. It is important to note that this multiple varies based on the attained age of the insured. MECs still qualify as life insurance under these rules, and therefore lump-sum death benefit proceeds paid from MEC policies are generally still received tax-free. However, other advantages are lost such as FIFO tax treatment, and withdrawals and loans may be subject to penalties.

[17] §1.101-1(b)(3)(i)(a)(b)(ii)

* If a policy is fully surrendered, allowed to lapse, or exchanged for another life insurance, annuity, or long term care policy, however, loans are taxable to the extent that the cash value exceeds the owner's tax basis in the contract.

› INCOME TAX TREATMENT OF LIVING PROCEEDS

The cash value build-up inside of a permanent insurance policy is not taxable as income if it is not withdrawn from the policy. Distributions of the cash value build-up inside a policy are permissible, however, and can be accomplished in several ways, including withdrawals from the cash value, loans, policy dividends, life settlements, and cash surrenders. The distribution ordering rules for withdrawals of cash value are generally first-in, first-out, or FIFO, which means that a policyholder may take a distribution consisting of a tax-free return of their premium. To determine the tax consequences, if any, of any of these types of transactions, the policy's tax basis must be determined. Tax, or cost basis, is established by adding total premiums contributed to the policy, and subtracting any dividends paid into the policy by the insurer. Furthermore, if any withdrawals consisting of a tax-free return of the policyholder's premium have been made, they subsequently reduce the tax basis of the policy.

› FIRST IN, FIRST OUT

FIFO tax treatment is one of the key tax benefits of most cash-value life insurance policies. This treatment allows policy owners to make withdrawals from the cash-value that are attributed to premiums paid into the policy with after-tax dollars. This provides the policy owner access to the cash-value as part of a tax-free return of premium, leaving the taxable growth portion of the cash-value untouched.

› COST BASIS

To determine the tax consequences, if any, of a particular life insurance transaction, the policy's tax basis must be determined. Tax, or cost basis, is established by adding total premiums contributed to the policy, and subtracting any dividends paid into the policy by the insurer. Furthermore, if any withdrawals consisting of a tax-free return of the policyholder's premium have been made, such amounts subsequently reduce the cost-basis of the policy.

› CASH WITHDRAWALS

If funds are withdrawn from a policy's cash value, it is largely treated as a nontaxable return of basis. Any excess of the amount of the distribution over the policyowner's basis, however, is taxable as income in the year of the withdrawal. There are some exceptions to this rule, including modified endowment contracts (MECs) which are subject to last in, first out (LIFO) withdrawal rules and certain transactions. Additionally, if a cash withdrawal from a non-MEC life insurance contract within the first 15-years results in a reduction in the death benefit (forced out gain), the gain is considered to be distributed first, followed by the investment in the contract up to the recapture ceiling.[18]

› POLICY LOANS

Generally, policy loans have no correlation with tax basis unless the policy is a modified endowment contract. If a policy is fully surrendered, allowed to lapse, or exchanged for another life insurance, annuity, or long term care policy, however, it is taxable to the extent that the cash value exceeds the owner's tax basis in the contract.

[18] §7702(f)(7)(b)

› LIFE SETTLEMENTS

Generally, proceeds received from a life settlement, up to the tax basis are free of income tax. Proceeds received in excess of the tax basis, up to the cash surrender value, however, are taxed as ordinary income. Finally, any remaining proceeds are subject to capital gains tax treatment.

› POLICY DIVIDENDS

Policy dividends are considered a nontaxable return of premium and therefore reduce the policyowner's tax basis. If combined overall dividends exceed total premiums paid into the policy, however, dividends are taxable to that extent. If policy dividends are used to lower the premium requirement or paid back into the policy to buy paid-up additions, the tax basis reduction resulting from the payment of the dividend is offset by a corresponding tax basis increase due to the dividend being treated as a premium payment for tax purposes.[19]

› CASH SURRENDER

If a policy is fully liquidated for cash, the amount includable in taxable income is the total surrender amount, minus the current basis in the policy. It is important to note that any dividends left to accumulate at interest are not included in the surrender value for tax purposes, as they would have already reduced the basis in the contract.

› 1035 EXCHANGE

Fully surrendering a cash value life insurance policy creates a taxable event when the total contract value exceeds the premiums paid into the contract. Section 1035 of the Internal Revenue Code (IRC) provides, however, that replacing one life insurance contract for another life insurance, annuity, or long term care contract is non-taxable when certain requirements are met. The policy owner may exchange a current policy for a new policy with the same owner and same insured (insured and annuitant must be the same when exchanging for an annuity), and the exchange is executed through a trustee-to-trustee transfer between the surrendering carrier and the receiving carrier. The policyholder cannot receive a check from the surrendering carrier and use the proceeds to purchase a new contract from the receiving carrier. This would be a disqualifying transaction resulting in a taxable event. In effect, the distribution from the surrendering carrier would be included in taxable income to the extent that the policy value exceeds premiums paid into the contract and is an irrevocable transaction.

§1035 Exchange Requirements

Permissible exchanges:

- ✓ Life insurance to life insurance
- ✓ Life insurance to nonqualified annuity
- ✓ Life insurance to long term care
- ✓ Nonqualified annuity to nonqualified annuity
- ✓ Nonqualified annuity to long term care
- ⊖ Nonqualified annuity to life insurance

[19] §72(e)(4)(b)

› MODIFIED ENDOWMENT CONTRACT

A life insurance policy that fails the *seven-pay* test is treated as a Modified Endowment Contract (MEC) for tax purposes. The spirit of the rule is to discourage excessive premium payments into the contract that would result in a fully paid-up policy before the end of a seven-year period, preventing a potentially infinite, large-scale tax shelter. The rule limits the sum of net level premiums from exceeding an amount sufficient to guarantee all future benefits of the policy paid over seven years. The seven-pay test is applied at policy inception, and again if there are any material changes to the policy, which include most increases and some decreases in future benefits. For instance, an increase in the death benefit amount may occur due to a flexible premium payment. It should also be noted that all single-premium life insurance policies are designated as MECs. Once a policy becomes a MEC, it will be classified as a MEC in the current year and all tax years thereafter. A life insurance policy that is determined to be a MEC will retain its tax-deferred status, but will be subject to earnings first, recovery of basis second, or LIFO tax treatment with respect to loans and most distributions. Gains in the policy must come out first and are includable in taxable income[20], and unless an exception applies, a 10% early-withdrawal penalty will also be enforced against policy owners who are younger than 59½ to the extent of any distributed gains.[21] The MEC policy death benefit is received free of income tax.

MEC Transactions Treated as LIFO[20]

- Cash withdrawals
- Loans secured by the policy value
- Loans utilized to pay premiums or other intentions
- Accrued interest on policy loans
- Policy assignment

MEC Transactions *Not* Treated as LIFO[20]

- Policy dividends utilized to purchase paid-up additions
- Surrender of paid-up additions to pay policy premiums
- Policy dividends retained by the insured to pay policy premiums

POLICY TYPE	MEC	NON-MEC
Tax-free death benefit	Yes	Yes
Surrender policy for cash	Yes	Yes
FIFO withdrawals	No	Yes
LIFO withdrawals	Yes	No
Unpaid policy loans taxable if policy is surrendered or exchanged	N/A*	Yes

* Distributions from Modified Endowment Contracts, including policy loans, are treated as earnings first and are taxed as ordinary income to the extent the cash value in the policy exceeds basis.

[20] §72(e)(2)(A)(B)(i)(ii) and §72(e)(4)(a)(i)(ii)(b)

[21] §72(v)(1)(2)(A)(B)(C)

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