Transamerica℠

Looking ahead

Income tax implications of life insurance living benefits

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Worthwhile financial guidance recognizes the bigger picture and anticipates the future. That's why we want to help you provide knowledge your clients can use to live their best life today, and for many years to come.

Healthcare costs and lost wages as a result of illness or injury can make a major impact on your clients' financial future. On the plus side, certain types of life insurance are designed to provide the confidence your clients and their loved ones need.

This document examines some of the potential tax implications with regard to qualifying health events and policy ownership. In general:

Terminal illness or chronic illness/long term care (LTC) benefits should be income tax free if the death benefit would have been income tax free upon the death of the insured. (These benefits would be taxable to the business for business-owned policies.)

Critical illness benefits should generally be income tax free when premiums are paid by the individual insured rather than by an employer.

To find out more:

Terminal/chronic illness benefits are governed by Internal Revenue Code (IRC) § 101(g) and are treated like an acceleration of the death benefit.

Critical illness benefits are treated like health insurance benefits under IRC § 104.

Long term care benefits are governed by Internal Revenue Code § 7702B and § 101(g). To sell products with long term care benefits, producers must generally be licensed to sell long term care in the state where the contract is sold.

Taxation of benefits based on policy ownership

The table below compares some of the differences in taxation based on ownership of the life insurance policy:

	Insured Owns Policy	Employer Owns Policy
Terminal Illness	Not taxable as income[1]	Taxable as income to employer;[2] but may be deductible by employer and taxable to employee if paid to employee as reasonable compensation
Chronic Illness/ LTC	Not taxable if less than per diem limit or actual long term carecosts,[3] depending on contract terms	Taxable as income to employer;[2] but may be deductible by employer and taxable to employee if paid to employee as reasonable compensation
Critical Illness	Not taxable as income when insured pays premium[4]	Most likely not taxable as income to employer;[5] but may be deductible by employer and then taxable to employee if paid to employee as reasonable compensation
Death Benefit	Not taxable as income[6]	Taxable unless IRC § 101(j) requirements met including notice and consent provided

[1] IRC § 101(g)(1)(A)
[2] IRC § 101(g)(5)
[3] IRC § 101(g)(1)(B); IRC §7702B(d)
[4] IRC § 104(a)(3)
[5] IRC § 104(a)(3), and Rugby Productions, Ltd. v. C.I.R., 100 T.C. 531 (1993)
[6] IRC § 101(a)

Third-party ownership

Living benefits are normally free from income tax even when the insured is not the owner. Some exceptions to the income tax free nature of living benefits when a third party is the owner of the contract are:

- Business-related policies: Terminal and chronic illness long term care benefits may not be exempted from income tax.
- If the policy has become subject to the transfer for value rule:[1] While critical illness benefits may fall outside the statutory transfer for value rule, they may also become taxable if the owner acquired the policy for money or in exchange for services or property after inception of the policy.[2]

Modified endowment contract (MEC) with a long term care rider

Generally, MECs follow the LIFO (last in, first out) rules for taxation so that any loans or withdrawals from a MEC result in taxable gains being distributed first before the nontaxable return of basis. However, when LTC benefits are paid out of a MEC from an LTC rider, the benefits received by the insured for long term care are not taxable because they are considered LTC rider benefits rather than withdrawals from the MEC.

In addition, one can do a tax-free 1035 exchange from a MEC contract to a MEC contract with an LTC rider and thereafter receive lifetime benefits for long term care without experiencing taxation of the benefits.

Lapsing a policy after receipt of living benefit

The general rules on surrender determine the tax consequences of allowing a policy to lapse, even after payment of an accelerated death benefit. When 100% of the policy face amount has been accelerated as a terminal illness benefit, the base policy and all riders will terminate.

When a policy lapse occurs after a chronic illness claim or long term care claim, there is no taxable income related to prior living benefit payments as they are considered a tax-free accelerated death benefit. Similarly, prior critical illness benefit payments are not taxable on a later lapse of the policy.

(NOTE: This differs from the tax treatment of the lapse of a policy with an outstanding loan in excess of basis in the policy. In that scenario, the outstanding loan balance is included as part of the amount realized, and the result is additional ordinary income to the policy owner.)

Qualified plans

If life insurance with accelerated death benefit riders is owned by a qualified plan, the plan documents should address living benefit riders.

- Long term care/chronic illness and critical illness riders may not be considered by the Internal Revenue Service (IRS) to be permissible incidental benefits in a qualified plan.
- Terminal illness riders in a qualified plan require attention, to the extent that a life insurance policy inside a qualified plan has cash value when the participant is terminally ill, because the distribution of living benefit payment from the plan could be viewed as a pro rata distribution of death benefit and cash value.

Insureds and plan trustees should consult with their tax advisors to evaluate the tax consequences of plan ownership of a life insurance policy with living benefit provisions.

Federal income tax reporting

Transamerica reports the payment of living benefits when required by the IRS on forms 1099-LTC and 1099-R. Taxpayers must consult with their professional legal and tax advisors to determine whether benefit payments are taxable and prepare their tax returns accordingly.

[1] IRC § 101(a)(2)
[2] Peoples Finance & Thrift Co. v. C.I.R., 12 T.C. 1052, 1055 (1949), aff'd 184 F.2d 836 (5th Cir. 1950)

Summary:

With the increasing popularity of hybrid life insurance products with chronic, critical, terminal, and long term care benefits, it's important to be aware of the issues that may arise due to tax consequences of these living benefits. Policies owned by businesses, policies in qualified plans, and any other policies not owned by the insured all require careful review so that the value of these benefits is understood and realized.

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