



# ADVANCED MATTERS

## INCOME TAX IMPLICATIONS OF LIVING BENEFITS

Over the past two decades, life insurance products have come to include benefits payable during the life of the insured as well as at death. More recently, hybrid life insurance with long term care (LTC) or chronic illness riders has proved popular in the marketplace, with sustained double-digit growth in product sales from 2009–12.<sup>1</sup> This early payout is called a living benefit (also known as accelerated death benefit, or ADB). Living benefits on a policy may be triggered when the insured experiences a qualifying chronic, critical or terminal illness. Exact requirements for living benefits depend on life expectancy and the terms of the life insurance contract. However, since the income tax-free receipt of life insurance proceeds is usually described as dependent on the death of the insured, the taxation of these living benefits has raised questions.

This document will examine 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 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.

### To Find Out More:

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

Critical illness benefits are treated like health insurance benefits under Revenue Code § 102-104

Long term care benefits are governed by Revenue Code § 7702B. 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 <sup>2</sup>	Even if notice and consent requirements of IRC § 101(j) are followed, taxable to employer under 101(g) (5); but may be deductible by employer and then taxable to employee if paid as compensation
Chronic Illness / LTC	Not taxable if under HIPAA limit or actual long term care costs <sup>3</sup>	Taxable as income to employer <sup>4</sup> ; but may be deductible by employer and then taxable to employee if paid as compensation
Critical Illness	Most likely not taxable as income <sup>5</sup>	Most likely not taxable as income to employer <sup>6</sup> ; but may be deductible by employer and then taxable to employee if paid as compensation <sup>7</sup>
Death Benefit	Not taxable as income <sup>8</sup>	Taxable unless IRC § 101(j) requirements met including notice and consent provided; for C-Corp may be subject to alternative minimum income tax

<sup>1</sup> LIMRA, 2012 Individual Life Combination Products Annual Review

<sup>2</sup> IRC § 101(g)(1)(a)

<sup>3</sup> IRC § 101(g); IRC § 7702B

<sup>4</sup> IRC § 101(g)(5)

<sup>5</sup> PLR 200339015, PLR 200339016, PLR 200627014, and PLR 200903001

<sup>6</sup> IRC § 104(a)(3); *Castner Garage, Ltd. v. C.I.R.*, 43 B.T.A. 1 (1940); but see *Peoples Finance & Thrift Co. v. C.I.R.*, 12 T.C. 1052 (1949) (concurring opinion), *aff'd* 184 F.2d 836 (5th Cir. 1950)

<sup>7</sup> IRC § 104(a)(3); IRS CCA 200974035

<sup>8</sup> IRC § 101(a)

## Third-Party Ownership

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Living benefits are normally free from income tax even when the insured is not the owner. However, if the policy is business related, chronic illness and long term care benefits are not exempted from income tax. The standard rule for death benefits applies to living benefits; both are generally free from income tax. The major exception is if the policy becomes subject to the transfer for value rule.<sup>9</sup>

Please see our Advanced Matters “Policy Transfers” (OLA 2249) for more details on transfer for value.

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.<sup>10</sup>

## Lapsing a Policy After Receipt of Living Benefit

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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

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If life insurance with accelerated death benefit riders is owned by a qualified plan, the plan documents should address living benefit riders. This is particularly important for terminal illness riders which are now widely available. It would seem that living benefit riders must follow the incidental benefit rules that apply to life insurance owned by qualified plans.<sup>11</sup>

- **Long term care/chronic illness and critical illness riders** may not be considered by the 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, 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

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Transamerica reports the payment of living benefits as required by the IRS on forms 1099-LTC and 1099-R. Transamerica cannot determine if the benefit payments are taxable to the recipient or not. Taxpayers must consult with their professional legal and tax advisors to determine if benefit payments are taxable or not and prepare their tax returns accordingly.

## Summary

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With the increasing popularity of hybrid life insurance products with chronic, critical, terminal and long term care benefits, it is 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.

## Contact Transamerica’s Advanced Marketing team for more information.

<sup>9</sup> IRC § 101(a)(2).

<sup>10</sup> *Peoples Finance & Thrift Co. v. C.I.R.*, 12 T.C. 1052, 1055 (1949), *aff’d* 184 F.2d 836 (5th Cir. 1950)

<sup>11</sup> Rev. Rul. 74-307, 1974-2 CB 126; Rev. Rul. 76-353, 1976-2 CB 127.

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