PacificCPE

COURSE
34751A

Life Insurance Taxation: An Overview

Life insurance intersects with federal income, estate, and gift tax rules in ways that surprise even experienced practitioners. This course walks through the full taxation picture — from the basic income tax exclusion and its exceptions to contract design, lifetime distributions, and accelerated benefits. It also covers estate planning with irrevocable trusts, specialized personal planning strategies, and business and retirement plan applications. Whether you advise individuals, business owners, or estates, this course helps you spot life insurance tax issues and guide clients with confidence.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the statutory definition of life insurance in IRC §7702.
- Recognize the general transfer-for-value rule of IRC §101(a)(2).
- Identify when a life insurance contract becomes a modified endowment contract (MEC).
- Recall the requirements of IRC §2042.
- Recognize why many ILITs grant beneficiaries a Crummey withdrawal power over trust contributions.
- Recall the characteristics of an absolute assignment of an existing policy to charity.
- Recall why Treasury Regulations impose "incidental benefit" limits.

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Chapter 1: LIFE INSURANCE AND THE FEDERAL INCOME TAX EXCLUSION

Chapter Objective

After completing this chapter, you should be able to:

- Recall the statutory definition of life insurance in IRC §7702.

LIFE INSURANCE AND THE FEDERAL TAX SYSTEM — AN OVERVIEW

Why Life Insurance Is Tax-Favored

No provision of the Internal Revenue Code creates a general exemption for "insurance" as such. Rather, Congress has chosen, since the origins of the modern income tax, to exclude from gross income amounts received under a life insurance contract paid by reason of the death of the insured. That policy choice — codified today at IRC §101(a)(1) — reflects a judgment that death benefits replace an economic loss (the insured's future earning capacity or the value of the insured's contribution to a household or business) rather than representing income in the ordinary sense. The exclusion is also administratively convenient: it spares the government from valuing and taxing an event, the insured's death, that is already the source of considerable hardship for survivors.

The favorable treatment does not stop at the income tax. Life insurance death benefits can also be structured to avoid inclusion in the insured's gross estate for federal estate tax purposes, and premium payments into certain trust arrangements can be structured to qualify for the annual gift tax exclusion. Because life insurance sits at the intersection of three separate taxing regimes — income tax, estate tax, and gift tax — and because each regime has its own definitions, ownership tests, and look-back periods, practitioners must analyze every life insurance transaction under all three regimes independently. A result that is entirely tax-free for income tax purposes (the death benefit itself) can simultaneously trigger estate tax inclusion, gift tax exposure on premiums, or generation-skipping transfer (GST) tax consequences if the trust holding the policy is not properly structured.

Example

Maria owns a $2,000,000 term life policy naming her adult son as beneficiary. On her death, her son receives the full $2,000,000 free of federal income tax under §101(a) — but if Maria had instead retained the right to change the beneficiary or borrow against the policy, that same $2,000,000 could be pulled into her taxable estate under the separate rules discussed in Chapter 4, even though the income tax result would not change.

The Three Tax Regimes at a Glance

Income tax. Governed principally by IRC §101 (general rule and exceptions), §72 (rules for distributions from life insurance and annuity contracts, including modified endowment contracts), §7702 (statutory definition of "life insurance contract" for federal tax purposes), and §7702A and §7702B (modified endowment contracts and qualified long-term care/chronic illness riders, respectively).

Estate tax. Governed principally by IRC §2042 (proceeds of life insurance included in the gross estate) and §2035 (certain transfers within three years of death, including transfers of life insurance policies, pulled back into the gross estate).

Gift tax. Governed principally by IRC §2501 and §2503, which determine whether a transfer of a policy, or a contribution used to pay premiums on a policy owned by another person or a trust, constitutes a taxable gift, and whether the gift qualifies for the annual exclusion as a present interest.

Types of Life Insurance Contracts

For tax purposes, the label an insurer places on a product (term, whole life, universal life, variable universal life, indexed universal life, survivorship/second-to-die) matters less than whether the contract satisfies the statutory definition of "life insurance" in IRC §7702. A contract must be a life insurance contract under applicable state law and must satisfy either the cash value accumulation test (CVAT) or the guideline premium and cash value corridor test (the "corridor test") of §7702. A contract that is overfunded relative to these tests loses its status as a life insurance contract for federal tax purposes; the inside buildup becomes currently taxable, and the death benefit may lose the §101(a) exclusion entirely. Practitioners should understand that §7702 compliance is generally the insurance company's responsibility (built into policy design and monitored through premium limits), but a policy owner who deviates from the illustrated premium schedule — for example, by paying additional unscheduled premiums into a flexible-premium universal life policy — can inadvertently cause a §7702 failure. This is separate from, and stricter than, the seven-pay test that determines modified endowment contract status, discussed in Chapter 3.

Observation

A policyholder pays several large, unscheduled premiums into a flexible-premium universal life policy to boost its cash value. If the cumulative premiums exceed the guideline premium limits under §7702, the policy loses its status as a life insurance contract altogether — meaning the annual growth in cash value becomes currently taxable each year, regardless of whether any withdrawal is ever made.

Roles: Owner, Insured, and Beneficiary

Three roles matter for tax analysis, and they need not be held by the same person:

- The owner holds the contractual rights in the policy: the right to change the beneficiary, borrow against cash value, surrender the policy, or assign it. For estate tax purposes, the owner's rights are the "incidents of ownership" discussed in Chapter 4.
- The insured is the person whose death triggers payment of the death benefit.
- The beneficiary is the person or entity entitled to receive the death benefit.

When the owner, insured, and beneficiary are three different people, gift tax issues can arise even during the insured's lifetime — most notably the "Goodman triangle" or "unholy trinity" problem discussed in Chapter 5, in which the death benefit paid to a third-party beneficiary is treated as a taxable gift from the policy owner to the beneficiary.

Example

David owns a policy insuring his wife, Elena, and names their daughter as beneficiary. Because David (the owner), Elena (the insured), and their daughter (the beneficiary) are three different people, the death benefit paid on Elena's death is treated as a gift from David to their daughter — even though the money never passed through David's hands.

THE GENERAL EXCLUSION RULE — IRC §101(A)

Statutory Text and Scope

IRC §101(a)(1) provides that, except as otherwise provided, gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. The exclusion applies regardless of who owns the policy, how large the death benefit is, and how the premiums were funded. There is no dollar cap on the general exclusion — unlike, for example, the $50,000 cap that applies to certain employer-provided group term life coverage under §79 (Chapter 3), the §101(a) exclusion for death benefits is unlimited in amount.

Observation

Whether a policy pays a $100,000 death benefit or a $50,000,000 death benefit, the entire amount is excludable from the beneficiary's gross income under §101(a) so long as no exception applies — there is no phase-out, cap, or means test tied to the size of the payment.

The exclusion applies to amounts paid under a "life insurance contract," a term defined by §7702 and further shaped by decades of case law and revenue rulings addressing arrangements that resemble insurance but were held not to qualify (for example, certain retained-asset accounts and some employer self-insurance arrangements).

"By Reason of the Death of the Insured"

The exclusion applies only to amounts paid because the insured died — not to every dollar an insurer ever pays under the contract. Living benefits such as cash surrender values, policy loans, and dividends are governed by different rules under §72, not §101(a). Accelerated death benefits paid before death to a terminally or chronically ill insured are treated, by a special rule in §101(g), as if paid by reason of death (Chapter 2).

Example

A policyholder receives an annual dividend check and, separately, takes a small withdrawal against cash value. Neither payment is excludable under §101(a) — both are living benefits governed by §72 — even though the same policy will pay an entirely tax-free death benefit when the insured eventually dies.

Lump-Sum Payment Versus Installments

The §101(a) exclusion covers the face amount of the death benefit whether it is paid in a single lump sum or left with the insurer and paid out over time (for example, under a settlement option). However, when proceeds are left with the insurer and paid in installments, any amount paid in excess of the face amount held back — economically, the interest the insurer credits on the retained proceeds — is taxable interest income to the beneficiary under §101(c) and (d). Beneficiaries who elect an installment or interest-only settlement option should be advised, and reminded each year, that the interest component is fully taxable even though the underlying death benefit is not.