Annuities and Living Proceeds: General Rules

Section 72 of the Internal Revenue Code governs the federal income taxation of all amounts received under annuity, endowment and life insurance contracts except death proceeds of life insurance. Death proceeds of life insurance are payable under a life insurance policy that has matured by reason of the insured’s death.

Section 72 of the Code, then, governs the income taxation of the following amounts:

* All amounts received under an immediate or deferred annuity contract;
* Amounts received from the lifetime surrender of an endowment or life insurance contract;
* Amounts received from the lifetime maturity of an endowment contract; and
* Dividends.

Except in the case of certain annuity contracts held by nonnatural persons, income credited on a deferred annuity contract is not taxed currently to the owner of the contract.

Amounts that are governed under Section 72 are divided into: (1) “amounts received as an annuity”; (2) amounts received as interest only; and (3) “amounts not received as an annuity.”

# Amounts Received as an Annuity

Treasury regulations state that: “In general, ‘amounts received as an annuity’ are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date.” Treas. Reg. §1.72-1(b).

Under the income tax law, therefore, the term “annuity” includes not only payments for a life or lives but also installment payments that do not involve life contingency, such as payments for a “fixed period” or payments of a “fixed amount.”

Payments are not “annuity” payments, however, unless they result from liquidation of a principal sum. See Rev. Rul. 75-255, 1975-2 CB 22. In other words, annuity payments are composed of both principal and interest. Payments of interest only are not “amounts received as an annuity.”

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The Internal Revenue Code provides specific rules, known as the “annuity rules,” for taxing “amounts received as an annuity.” The annuity rules apply in taxing life income and other installment payments, whether the principal sum being liquidated is the single premium for an immediate annuity, the lifetime maturity value of an endowment, retirement income, or deferred annuity contract, or the cash surrender value of any type of annuity or life insurance contract.

The annuity rules are designed to permit the annuitant to exclude a fixed portion of each payment from his gross income as a tax-free return of his cost, and to tax the balance of each payment as earned interest.

# Amounts Received as Interest Only

The annuity rules do not apply to payments of interest only. If a company holds a principal sum at interest only, the full amount of each interest payment is taxable income.

# Amounts Not Received as an Annuity

All other amounts taxable under section 72 of the Code are “amounts not received as an annuity.” These include:

* Dividends;
* A lump sum payment of the lifetime maturity value of an endowment, retirement income or deferred annuity contract;
* A lump sum payment of the cash surrender value of any type of annuity or life insurance contract;
* The amount payable upon death of an annuitant prior to the maturity of a deferred annuity; and
* The refund (or balance of guaranteed payments) received by the beneficiary under a life income settlement with refund or period certain guarantee.

Whether a particular sum is to be properly labeled as an “amount not received as an annuity” is not always clear. In one instance, the IRS issued (and subsequently revoked) a private letter ruling which found that where a single contract provided both an immediate annuity for a term and a deferred annuity to begin at a specified date in the future, the two elements were treated as two separate annuity contracts where the

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premiums, reserves, surrender values, and benefits provided by the immediate annuity and the deferred annuity were clearly separable. Thus, amounts received under the immediate annuity before the deferred annuity starting date were not considered amounts not received as an annuity and separate exclusion ratios were determined for each. Let. Rul. 8720011 revoked by Let. Rul. 9015010.

Where, as part of the purchase of a variable annuity, a taxpayer entered into an investment advisory agreement which stated that the company issuing the annuity would be solely liable for payment of a fee to an investment adviser who would manage the taxpayer’s funds in the variable accounts, the fee was considered to be an amount not received as an annuity and, thus, includable in the taxpayer’s income to the extent allocable to the income on the contract. Let. Rul. 9342053.

Responding to the involvement of several insurance companies in insolvency proceedings, the Internal Revenue Service has stated that modification of an annuity, life insurance, or endowment contract after December 31, 1990, that is necessitated by the insurer’s insolvency will not affect the date on which such contract was issued, entered into, or purchased for purposes of Code section 72. Rev. Proc. 92-57, 1992-2 CB 410; Let. Rul. 9239026. The date is not affected by assumption reinsurance transactions entered into by the insurer provided that the terms and conditions of the policies, other than the insurer, do not change. Let. Ruls. 9530027, 9323022, 9305013.

There are rules on whether an annuity will be classified as a “debt instrument” under the original issue discount rules. The contract will be taxed under Code section 72 if either (1) depends on the life expectancy of one or more individuals, or (2) is issued by an insurance company (or certain tax-exempt entities) where there is no consideration other than cash or another annuity contract, where an election is made by a beneficiary on the death of an insured person, or as part of a qualified pension or employee benefit plan. IRC Sec. 1275(a)(1)(B).

# Annuity Contracts – Taxation

The Interest First Rule

Policy dividends, cash withdrawals, and amounts received on partial surrender under annuity contracts entered into *after* August 13, 1982 are taxable as income to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract. IRC Sec. 72(e). Any excess will be treated as a tax-free return of investment.

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Note that a loan under the contract and the value of any portion of an annuity contract assigned or pledged is treated like a cash withdrawal for the purpose of this rule. Cash value is determined for this purpose without regard to any surrender charge. IRC Sec. 72(e)(3).

In other words, these amounts are treated as distributions of interest first and only second as recovery of cost. (In addition, taxable amounts may be subject to a 10% penalty tax unless paid after age 59½ or disability or under some other exception.

Amounts received which are allocable to an investment made after August 13, 1982 in an annuity contract entered into before August 14, 1982 are treated as received under a contract entered into after August 13, 1982 and are subject to the “interest first” rule. IRC Sec. 72(e)(5).

If an annuity contract has income allocable to pre-August 14, 1982 and post-August 13, 1982 investments, the amount received is allocable first to investments made prior to August 14, 1982, then to income accumulated with respect to such investments (under the “cost recovery” rule, see below), then to income accumulated with respect to investments made after August 13, 1982, and finally to investments made after August 13, 1982 (under the “interest-first” rule). Rev. Rul. 85-159, 1985-2 CB 29.

For tax years beginning after 2009 (for contracts issued after 1996), a charge against the cash value of an annuity contract or a life insurance contract (including a modified endowment contract (MEC)) made as a payment for a qualified long-term care insurance contract which is part of the contract or a rider to the contract will not be included in income, but will reduce the investment in the contract. IRC Sec. 72(e)(11), as added by PPA 2006.

The Cost Recovery Rule

Policy dividends, cash withdrawals, amounts received on partial surrender, and loans under annuity contracts entered into *before* August 14, 1982 (and allocable to investment in the contract made before August 14, 1982) are taxed under the “cost recovery rule.” Under the cost recovery rule, the taxpayer may receive all such amounts tax-free until he has received tax-free amounts equal to his investment in the contract. Thereafter such amounts are taxable. IRC Sec. 72(e)(5).

*For example*: An individual purchased an annuity contract on March 1, 1973 for $100x. In December, 1982, the taxpayer paid an additional premium of $50x. On March 1, 1983 the taxpayer made a partial surrender and received $160x. The cash value of the annuity was $200x as a result of (1) $100x premiums paid before

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August 14, 1982; (2) $50x in premiums paid after August 13, 1982; (3) $49x in accumulations attributable to investments made prior to August 14, 1982; and (4) $1x in accumulations attributable to investments made after August 13, 1982. The first $100x withdrawn was pre-August 14 investment (return of capital), the next $49x was ordinary income allocable to the pre-August 14, 1982 investment; the next $1x was ordinary income allocable to income accumulations on post-August 13, 1982 investment. The remainder of the amount withdrawn ($10x) is return of capital invested after August 13, 1982. (From Rev. Rul. 85-159, above.)

The interest first rule does not apply to amounts received under pension, profit sharing or stock bonus plans, under annuities purchased by any such plan or under Section 403(b) tax sheltered annuities.

# Annuity Contracts – Transfers without Adequate Consideration

An individual who transfers any annuity contract issued after April 22, 1987, for less than full and adequate consideration will be treated as having received an “amount not received as an annuity” unless the transfer is between spouses or incident to a divorce under Code section 1041’s nonrecognition rule.

The amount the transferor will be deemed to have received is the *excess* of the cash surrender value of the contract at the time of the transfer *over* the investment in the contract at that time. IRC Sec. 72(e)(4)(C). The transferee’s investment in the contract will include the amount, if any, included in income by the transferor. IRC Sec. 72(e)(4)(C)(iii).

The purpose behind the “interest first” rules applicable to contracts entered into after August 13, 1982 is to limit the tax advantages of deferred annuity contracts to long term investment goals, such as income security, and to prevent the use of tax deferred inside build-up as a method of sheltering income on freely withdrawable short term investments.

Therefore, other amounts received under annuity contracts, which are neither interest nor annuities, are taxed under the cost recovery rule (rather than the interest first rule), regardless of when entered into. These amounts include lump sum settlements on complete surrender, annuity contract death benefits, and amounts received in full discharge of the obligation under the contract which are in the nature of a refund of consideration, such as a guaranteed refund under a refund life annuity settlement. IRC Sec. 72(e)(5).

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# Annuity Contracts – Tax-Free Exchanges

In order to give effect to the grandfathering of pre-August 14, 1982 annuity contracts, a replacement contract obtained in a tax-free exchange of annuity contracts succeeds to the status of the surrendered contract. In other words, the investment in the replacement contract will be considered made on, before or after August 13, 1982 to the same extent the investment was made on, before or after August 13, 1982 in the replaced contract. Rev. Rul. 85-159, 1985-2 CB 29.

# Annuity Contracts – Multiple Contracts

All annuity contracts entered into after October 21, 1988 which are issued by the same company to the same policyholder during any calendar year will be treated as one annuity contract for purposes of determining under the above rules the amount of any distribution that is includable in income. IRC Sec. 72(e)(11).

This aggregation rule does not apply to distributions received under qualified pension or profit sharing plans, from a Section 403(b) contract, or from an IRA. OBRA ’89 Sec. 7815(a)(3). The Conference Report on OBRA ’89 also states the aggregation rule does not apply to immediate annuities.

# Annuity Contracts – Premature Distribution Penalty

In order to discourage the use of deferred annuity contracts as short term tax sheltered investments, penalties are attached to certain “premature” payments under annuity contracts. With certain exceptions noted below, a tax of 10% is imposed on any payment received in taxable years beginning after December 31, 1986, under an annuity contract to the extent the payment is includable in income. IRC Sec. 72(q).

The 10% penalty tax does not apply to any of the distributions discussed below.

After Age 59½

The 10% penalty tax does not apply to any payment made on or after the date on which the taxpayer becomes age 59½.

Due to Disability

Any payment attributable to the taxpayer’s becoming disabled is also not subject to the 10% penalty tax.

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From Certain Retirement Arrangements

The 10% penalty tax does not apply to any payment made from a qualified pension, profit sharing or stock bonus plan, or under a contract purchased by such a plan. It also does not apply to any payment made under a Section 403(b) tax sheltered annuity, or from an individual retirement account or annuity, or from a contract provided life insurance company employees under certain retirement plans. (However, a different 10% penalty may apply.)

After Death of Contract Holder

Any payment made on or after the death of the holder (or the primary annuitant in the case where the holder is a non-individual) is not subject to the 10% penalty tax. (The primary annuitant is the individual the events in the life of whom are of primary importance in affecting the timing or amount of payout under the contract.)

From a Qualified Funding Asset

Another exception to the 10% penalty tax is for any payment under a qualified funding asset. A qualified funding asset is defined as any annuity contract issued by a licensed insurance company which is purchased as a result of a liability to make periodic payments for damages, by suit or agreement, on account of personal physical injury or sickness and which meets the definition of Code section 130(d) without regard to whether there is a qualified assignment of liability to make the payments.

Over Life Expectancy

Another exception to the 10% penalty tax is for any payment which is part of a series of substantially equal periodic payments made (not less frequently than annually) for the life or life expectancy of the taxpayer or the joint lives or joint life expectancies of the taxpayer and beneficiary.

Payments excepted from the 10% penalty by reason of this exception may be subject to recapture if a change in the series of payments occurs (other than by reason of death or disability) (1) prior to the taxpayer reaching age 59½ or (2) before the end of a five-year period beginning on the date of the first payment even if the taxpayer has reached age 59½.

The tax on the amount recaptured is imposed in the first taxable year of the modification and is equal to the tax (as determined under regulations) which would have been imposed (plus interest) had the exception not applied.

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In a private letter ruling, payments received from an annuity over a taxpayer’s life expectancy as a result of the taxpayer exercising the contract’s “systematic withdrawal option” were considered subject to the 10% penalty tax since, under the terms of the contract, the taxpayer retained the right to alter or stop the systematic withdrawals. Let. Rul. 9115041.

The Service has announced that the three methods used to avoid the 10% penalty when making substantially equal periodic payments from a qualified retirement plan may also be used to qualify as substantially equal periodic payments from a nonqualified annuity. The “one time election” to change methods may also be used by owners of nonqualified annuities. Finally, there will be no penalty if an individual depletes an account by using one of the approved methods. Notice 2004-15, 2004-9 IRB 526.

From an Immediate Annuity

The 10% penalty tax does not apply to any payment made under an immediate annuity contract. An immediate annuity contract is defined as an annuity purchased with a single premium or annuity consideration, the annuity starting date of which is no later than one year from the date of purchase, and which provides for a series of substantially equal periodic payments to be made no less frequently than annually during the annuity period. IRC Sec. 72(u)(4)). See Let. Rul. 200036021.

Where a deferred annuity contract was exchanged for an immediate annuity contract, the purchase date of the new contract for purposes of the 10% penalty tax was considered to be the date upon which the deferred annuity was purchased. Thus, payments from the replacement contract did not fall within the immediate annuity exception to the penalty tax. Rev. Rul. 92-95, 1992-2 CB 43.

From An Annuity Received Upon Termination of a Retirement Plan

Another exception to the 10% penalty tax is for any payment made from an annuity purchased by an employer upon the termination of a qualified plan and held by the employer until the employee’s separation from service.

# Annuity Contracts Owned by Nonnatural Persons

To the extent that contributions are made after February 28, 1986 to a deferred annuity contract held by a corporation or other entity not a natural person, the contract is not treated for tax purposes as an annuity contract. IRC Sec. 72(u)(1).

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Income on the contract is treated as ordinary income received or accrued by the owner during the taxable year. IRC Sec. 72(u)(1). “Income on the contract” is the *excess of* (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract during the taxable year and any prior taxable year *over* (2) the sum of the net premiums (amount of premiums paid under the contract reduced by any policyholder dividends) under the contract for the taxable year and prior taxable years and any amounts includable in gross income for prior taxable years under this requirement. IRC Sec. 72(u)(2).

This rule does not apply to any annuity contract which (1) is acquired by the estate of a decedent by reason of the death of the decedent; (2) is held under a qualified pension, profit sharing, or stock bonus plan, as a Code section 403(b) tax sheltered annuity or under an individual retirement plan; (3) is purchased by an employer upon the termination of a qualified pension, profit sharing, or stock bonus plan or tax sheltered annuity program and held by the employer until all amounts under the contract are distributed to the employee for whom the contract was purchased or to his beneficiary; (4) is an immediate annuity (i.e., an annuity which is purchased with a single premium or annuity consideration, the annuity starting date of which is no later than one year from the date of purchase, and which provides for a series of substantially equal periodic payments to be made no less frequently than annually during the annuity period); or (5) is a qualified funding asset (as defined in Code section 130(d) but without regard to whether there is a qualified assignment). IRC Sec. 72(u)(3). For this purpose, then, a qualified funding asset is any annuity contract issued by a licensed insurance company which is purchased as a result of a liability to make periodic payments for damages, by suit or agreement, on account of personal physical injury or sickness.

An annuity contract held by a trust or other entity as agent for a natural person is considered held by a natural person. IRC Sec. 72(u)(1). According to the conference explanation (TRA ’86), if a nonnatural person is the nominal owner of an annuity contract but the beneficial owner is a natural person, the annuity contract will be treated as though held by a natural person. H.R. Conf. Rep. No. 99-841 (TRA ’86) *reprinted in* 1986-3 CB 401.

According to the IRS, a trust that owned an annuity contract which was to be distributed, prior to its annuity starting date, to the trust’s beneficiary, a natural person, was considered to hold the annuity contract as an agent for a natural person. Let. Ruls. 9204014, 9204010. Where the trustee of an irreovocable trust purchased three single premium deferred annuities, naming the trust as owner and beneficiary of the contracts and a different trust beneficiary as the annuitant of each contract, the nonnatural person rule was not applicable. The terms of

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the trust provided that the trustee would terminate the trust and distribute an annuity to each trust beneficiary after a certain period of time. Let. Rul. 199905015. Additionally, the Service concluded that the nonnatural person rule does not apply to a trust which had invested trust assets in a single premium deferred variable annuity where the same individual was the sole annuitant under the contract and the sole life beneficiary of the trust. Let. Rul. 9752035.

Where a trustee’s duties were limited to purchasing an annuity as directed by an individual and holding legal title to the annuity for his sole benefit and the trustee was not able to exercise any rights under the annuity contract unless directed to do so by the individual, the Service concluded that the trustee was acting as an agent for a natural person. Let. Rul. 9639057. Further, where the trustee of an irrevocable trust purchased an annuity and had the power to select an annuity settlement option or terminate the annuity contract, the annuity was still considered to be owned by a natural person. Let. Rul. 199933033.

An employee-grantor secular trust which held a variable annuity was also considered to hold the contract for a natural person. Let. Rul. 9316018. In a fact situation involving a master trust receiving after-tax participant contributions, the Service concluded that the trustee was acting as an agent for the participant where the trustee’s duties were limited to receiving contributions, forwarding the contributions to an insurance company to be paid into a particular group annuity contract, and holding legal title to the contract for the participant’s sole benefit. The Service noted that the trustee would be unable to exercise any rights under the annuity contract unless directed by the participant. Let. Rul. 9810015.

A group annuity contract held by a trust for the purpose of providing retirement benefits to a group of natural persons through a plan that was not a qualified retirement plan was considered by the Service to be owned for a natural person. Let. Rul. 200018046.

Further, a bank holding an annuity contract used to fund a pre-need funeral arrangement as trustee was considered to hold the annuity contract as an agent for a natural person. Let. Rul. 9120024. However, a charitable remainder unitrust was not considered to hold an annuity contract as an agent for a natural person and, thus, was required to include income on any annuity contracts in ordinary income each year. Let. Rul. 9009047.

These requirements apply “to contributions to annuity contracts after February 28, 1986.” TRA ’86, Sec. 1135(b). It is clear that if all contributions to the contract are made after February 28, 1986 the requirements apply to the contract. It seems clear enough

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that if no contributions are made after February 28, 1986 to an annuity contract, a contract held by a nonnatural person is treated for tax purposes as an annuity contract and is taxed under the annuity rules.

However, if contributions have been made both before March 1, 1986 and after February 28, 1986 to contracts held by nonnatural persons, it is not clear whether the income on the contract is allocated to different portions of the contract and whether the portion of the contract allocable to contributions before March 1, 1986 may continue to be treated as an annuity contract for income tax purposes. The Code makes no provision for separate treatment of contributions to the same contract made before March 1, 1986 and those made after February 28, 1986.

For taxable years which began in 1987, 1988, and 1989, corporate-owned annuities may have resulted in exposure to the alternative minimum tax to the extent that such corporate-owned annuities resulted in an increase in a corporation’s book income. IRC Sec. 56.

# Annuity Contracts Not Meeting Post-Death Distribution Requirements

Generally

A contract issued after January 18, 1985 will not be treated for tax purposes as an annuity contract unless it provides that (1) if any holder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion will be distributed at least as rapidly as under the method of distribution being used as of the date of the holder’s death and (2) if any holder dies before the annuity starting date, the entire interest in the contract will be distributed within 5 years after the holder’s death. IRC Sec. 72(s)(1). In the case of a joint and survivor annuity issued after April 22, 1987, these distribution requirements are imposed at the first death. TRA ’86, Sec. 1826(b).

If any portion of the holder’s interest is to be distributed to a designated beneficiary over the life of such beneficiary, (or over a period not extending beyond the life expectancy of the beneficiary), and such distribution begins not later than one year after the holder’s death, then such portion will be treated as distributed on the day such distributions begin. IRC Sec. 72(s)(2).

*Example*: A (age 50) buys an annuity contract and is the owner. He names his son (age 25) as the annuitant, with annuity payments to begin when his son becomes age 45. The father dies at age 58 and the son (now age 33) becomes the new owner of the contract. Under the provisions, there must be a distribution of the entire

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interest in the contract within five years of the father’s death or there must be annuitization of the contract within one year of such date.

If the designated beneficiary is the surviving spouse of the holder, then the distribution rules are applied by treating the spouse as the contract-holder. IRC Sec. 72(s)(3).

Effect of Exchange

According to the report of the conference committee (TRA ’84), an annuity contract issued after January 18, 1985, in exchange for one issued earlier will be considered a new contract and subject to the distribution requirements.

Rule Not Applicable to Certain Distributions

Slightly different distribution requirements apply with respect to qualified pension, profit sharing and stock bonus plans, Code section 403(b) tax sheltered annuities, and individual retirement annuities. A “qualified funding asset” (an annuity contract purchased to fund periodic payments of damages on account of personal injury or sickness and which meets the definition of Code section 130(d) without regard to whether there is a qualified assignment) is not subject to these requirements.

Contract Held by Other Than an Individual

Where the holder of a contract issued after April 22, 1987, is a corporation or other nonindividual, the primary annuitant will be treated as the holder of the contract. *Primary annuitant* means the individual whose life is of primary importance in affecting the timing or amount of the payout under the contract (e.g., the measuring life). IRC Sec. 72(s)(6). For purposes of the distribution requirements, a change in the primary annuitant of such a contract will be treated as the death of the holder. IRC Sec. 72(s)(7).

# Life Insurance Policies – Taxation

Generally, living proceeds received under life insurance policies and endowment contracts are taxed under the “cost recovery rule”. In other words, such amounts are included in gross income only to the extent they exceed the investment in the contract (as reduced by any prior excludable distributions under the contract).

One exception to this general rule concerns life insurance policies that have become classified as modified endowment contracts by failing the seven pay test of Section 7702A(b), the requirements of which are discussed below. Generally, distributions from modified endowment contracts are taxed under the “interest-first” rule.

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For tax years beginning after 2009 (for contracts issued after 1996), a charge against the cash value of an annuity contract or a life insurance contract (including a modified endowment contract (MEC)) made as a payment for a qualified long-term care insurance contract which is part of the contract or a rider to the contract will not be included in income, but will reduce the investment in the contract. IRC Sec. 72(e)(11), as added by PPA 2006.

Additionally, cash distributions received as a result of certain changes in the benefits of a life insurance contract may not be taxed under the cost recovery rule, but under the interest-first rule. Any change in the benefits under a life insurance contract or in other terms of the contract (other than automatic increases such as change due to the growth of the cash surrender value, payment of guideline premiums, or changes initiated by the company) which was not reflected in any earlier determination or adjustment will require a redetermination as to whether the definitional guidelines of Code section 7702 are still satisfied. IRC Sec. 7702(f)(7)(A). (However, a modification made to a life insurance contract after December 31, 1990, that is necessitated by the insurer’s financial insolvency will not cause retesting under Code section 7702(f)(7)(B)-(E). Rev. Proc. 92-57, 1992-2 CB 410; Let. Ruls. 9239026, 9305013.)

If such a change occurs during the 15-year period beginning on the issue date of the policy *and* reduces the benefits under the contract, then any cash distribution made to the policyholder as a result of such change will be taxed as ordinary income to the extent there is income on the contract; however, the amount to be included will be limited to the applicable recapture ceiling. IRC Sec. 7702(f)(7)(B).

If the change occurs during the 5-year period beginning on the issue date of a policy which originally qualified under Section 7702 by satisfying the cash value accumulation test (i.e., a traditional life policy), the recapture ceiling is the *excess of* the cash surrender value of the contract immediately before the reduction *over* the net single premium immediately after the reduction. If the change occurs during the 5-year period beginning on the issue date of a policy which originally qualified under Code section 7702 by satisfying the guideline premium/cash value corridor tests (i.e., a universal life policy), the recapture ceiling is the greater of (1) the *excess of* the aggregate premiums paid under the contract immediately before the reduction *over* the guideline premium limitation for the contract, taking into account the proper adjustment for the change in benefits; or (2) the *excess of* the cash surrender value of the contract immediately before the reduction *over* the cash value corridor immediately after the reduction.

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If the change occurs after the 5-year period and during the 15-year period beginning on the date of issue of the policy, the recapture ceiling is the *excess of* the cash surrender value of the contract immediately before the reduction *over* the cash value corridor immediately after the reduction.

Distributions made in anticipation of a reduction in benefits under the contract will be treated as resulting from a change in the contract. Any distribution which reduces the cash surrender value of a contract and which is made within two years before a reduction in benefits under such contract will be treated as made in anticipation of a reduction.

# Life Insurance Policies – Modified Endowment Contracts (MECs)

Definition

As mentioned above, distributions, including policy loans, from life insurance policies that have become classified as modified endowment contracts (MECs) are taxed differently than distributions from policies which are not modified endowment contracts. Generally, Section 7702A of the Internal Revenue Code, created by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA ’88), defines a modified endowment contract as one which meets the requirements of IRC Sec. 7702, was entered into on or after June 21, 1988, and fails to meet the seven pay test.

Seven Pay Test

A life insurance contract will fail the seven pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of the seven level annual payments. IRC Sec. 7702A(b).

Generally, the “amount paid” under the contract is defined as the premiums paid less distributions not including amounts includable in gross income. An amount received as a loan or the repayment of a loan does not affect the amount paid under the contract. H. R. Conf. Rep. No. 100-1104 (TAMRA ’88) *reprinted in* 1988-3 CB 593. Additionally, amounts paid as premiums during the contract year but returned to the policyholder with interest within 60 days after the end of the contract year will reduce the sum of the premiums paid during the contract year. IRC Sec. 7702A(e)(1). The interest paid on the premiums returned must be included in gross income. IRC Sec. 7702A(e)(1)(C).

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Where a whole life insurance policy is coupled with an increasing whole life rider and a term insurance rider and the amount of coverage provided under the term rider increases or decreases solely in relation to the amount of coverage provided by the base policy and whole life rider, the IRS has ruled privately that the policy’s “future benefits” for purposes of Section 7702A(b) are equal to the aggregate amount of insurance coverage provided under the base policy, the whole life rider, and the term insurance rider at the time the policy is issued. Let. Rul. 9519023. Where a variable whole life policy is coupled with a 20-year decreasing term rider, the future benefits for purposes of Section 7702A(b) are equal to the coverage under the base policy plus the lowest amount of coverage under the term rider at any time during the first seven contract years. Let. Rul. 9513015.

The seven level premiums are determined when the contact is issued and the first contract year death benefit is deemed to be provided to the contract’s maturity, disregarding any scheduled death benefit decrease after the first seven years. IRC Sec. 7702A(c)(1).

If there is a reduction in benefits under the contract within the first seven contract years, the seven pay test is applied as if the contract had originally been issued at the reduced benefit level. However, any reduction in benefits due to the nonpayment of premiums is not taken into account if the benefits are reinstated within 90 days after the reduction. IRC Sec. 7702A(c)(2).

In the case of a contract which pays a death benefit only upon the death of one insured that follows or occurs at the same time as the death of another insured, if the death benefit is reduced below the lowest level of death benefit provided during the contract’s first seven years, the modified endowment contract rules must be applied as if the contract had originally been issued at that lower benefit level. This rule is effective for contracts entered into on or after September 14, 1989. IRC Sec. 7702A(c)(6).

Distributions

Generally, distributions, including loans, from a modified endowment contract, are taxable as income at the time received to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract. IRC Sec. 72(e). Basically, this means that distributions from modified endowment contracts are taxed as income first and recovery of basis second. The investment in the contract is increased to the extent that a distribution was includable in the taxpayer’s income. A loan that is retained by the insurance company to pay policy premiums is considered an

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amount received under the contract. H. R. Conf. Rep. No. 100-1104 (TAMRA ’88) *reprinted in* 1988-3 CB 592.

For tax years beginning after 2009 (for contracts issued after 1996), a charge against the cash value of a MEC made as a payment for a qualified long-term care insurance contract which is part of the contract or a rider to the contract will not be included in income, but will reduce the investment in the contract. IRC Sec. 72(e)(11), as added by PPA 2006.

Under regulations, distributions in anticipation of a failure of the seven pay test are also taxed in this manner. A distribution made within two years prior to the failure of the seven pay test is a distribution made in anticipation of a failure. IRC Sec. 7702A(d).

This manner of taxation for distributions (i.e., income first, recovery of basis second) does not apply to the assignment or pledge of a modified endowment contract to pay burial or prearranged funeral expenses if the contract’s maximum death benefit does not exceed $25,000. IRC Sec. 72(e)(10)(B).

For the purpose of determining the amount includable in gross income, all modified endowment contracts issued by the same company to the same policyholder within any calendar year are treated as one modified endowment contract. IRC Sec. 72(e)(11). This rule does not apply generally to contracts purchased by a trust described in Section 401(a) which is exempt from tax under Section 501(a), purchased as part of a Section 403(a) plan, described in Section 403(b), or to an individual retirement annuity or an individual retirement account. IRC Sec. 72(e)(11).

Penalty Tax

Code section 72(q), added to the Code by TAMRA ’88, imposes a 10 percent penalty tax on any amount received by a taxpayer under a modified endowment contract that is includable in gross income unless the distribution is made after the taxpayer becomes disabled, attains age 59½ or the distribution is part of a series of substantially equal periodic payments made for the taxpayer’s life or life expectancy or the joint lives or joint life expectancies of the taxpayer and his beneficiary.

Effective Date

Subject to the following exceptions, life insurance contracts entered into on or after June 21, 1988, are subject to the seven pay test. TAMRA ’88 Sec. 5012(e)(1). Contracts entered into prior to this date are “grandfathered” for purposes of the seven pay test.

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If a grandfathered contract’s death benefit increases by more than $150,000 over the death benefit in effect as of October 20, 1988, the contract becomes subject to the material change rules (discussed below) and may lose its grandfathered status. This rule does not apply if the contract required at least seven annual premiums as of June 21, 1988, and the policyholder continues to make at least seven annual premium payments. TAMRA ’88 Sec. 5012(e)(2) as amended by OBRA ’89 Sec. 7815(a)(2). In determining whether a material change has occurred, the death benefit payable as of June 20, 1988, rather than the lowest death benefit payable during the first seven years is applicable. H.R. Conf. Rep. No. 100-1104, (TAMRA ’88) *reprinted in* 1988-3 CB 595-596.

A policy entered into before June 21, 1988, may lose its grandfathered status and, therefore, be treated as if it were entered into after this date, if (1) the policy death benefit is increased or an additional qualified benefit is purchased on or after June 21, 1988, and (2) prior to June 21, 1988, the contract owner did not have the right to obtain such an increase or addition without providing additional evidence of insurability. If a term life insurance contract is converted after June 20, 1988, to a policy that is not term insurance, without regard to the right of the owner to such a conversion, the policy will lose its grandfathered status. TAMRA ’88 Sec. 5012(e)(3).

A policy entered into before June 21, 1988, did not lose its grandfathered status where the insurer changed the policy loan provision to make interest payable in arrears rather than in advance. Let. Ruls. 9412023, 9117011. See also Let. Rul. 9150045. The Service has stated that modification of a life insurance contract after December 31, 1990, that is necessitated by the insurer’s insolvency will not affect the date on which the contract was issued, entered into, or purchased for purposes of Code section 7702. Rev. Proc. 92-57, 1992-2 CB 410; Let. Ruls. 9239026, 9305013.

If a modified endowment contract that requires the payment of at least seven annual premiums was entered into after June 20, 1988, but before November 10, 1988, and was then exchanged within the three months following November 10, 1988, for a contract which meets the requirements of the seven pay test the new contract will not be treated as a modified endowment contract if the taxpayer recognized gain, to the extent that there was any, on the exchange. TAMRA ’88 Sec. 5012(e)(4).

Material Changes to the Contract

If there is a material change in the contract’s benefits or terms, the contract will be treated as a new contract entered into on the day the material change was effective and the seven pay test, with appropriate adjustments to reflect the cash surrender value of

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the contract, must be met again. IRC Sec. 7702A(c)(3)(A). However, modification of a life insurance contract after December 31, 1990, that is necessitated by the insurer’s financial insolvency will not cause a new seven year period for purposes of the seven pay test to commence. Rev. Proc. 92-57, 1992-2 CB 410; Let. Ruls. 9239026, 9305013.

For a contract that has been materially changed the seven pay premium for each of the seven years following the change is reduced by the cash surrender value of the contract as of the effective date of the material change multiplied by a fraction, the numerator of which is the seven pay premium for future benefits under the contract and the denominator is the net single premium for future benefits under the contract. H.R. Conf. Rep. No. 100-1104, (TAMRA ’88) *reprinted in* 1988-3 CB 595.

A material change is defined as any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract. IRC Sec. 7702A(c)(3)(B). However, any increase due to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the first seven contract years or to the crediting of interest or other earnings, including dividends, is not considered a material change.

Additionally, to the extent provided in regulations, any cost-of-living increase funded over the period during which premiums are required to be paid under the contract and based on a broad-based index, is not considered a material change. IRC Sec. 7702A(c)(3)(B).

For purposes of Code Sections 101(f), 7702, and 7702A, a material change to a life insurance contract does not occur when a rider which is treated as a qualified long-term care insurance contract under Code section 7702B is issued or when any provision that is required to conform to any other long-term care insurance rider to these requirements is added. Health Insurance Portability and Accountability Act of 1996 (P.L. 104-491), Sec. 321(f)(4).

*Fixing accidental MECs*. The Service has updated its procedures for correcting inadvertent, non-egregious violations of the MEC rules. See Rev. Proc. 2008-39, 2008-29 IRB 143, *modifying and superseding*, Rev. Proc. 2001-42, 2001-36 IRB 212 and Rev. Proc. 2007-19, 2007-7 IRB 515.

Dividends

According to the Conference Committee’s Report, any dividend of a modified endowment contract that is retained by the insurer to pay either principal or interest on a policy loan is an amount received under the contract. Any dividend that is retained by

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the insurer for purposes of purchasing paid-up insurance is not an amount received under the contract. H.R. Conf. Rep. No. 100-1104, (TAMRA ’88) *reprinted in* 1988-3 CB 592.

Policy Exchanges

The effect of a Section 1035 exchange on the grandfathered status of a policy issued prior to June 21, 1988, and thus not subject to the seven pay test of Section 7702A is not entirely clear. (See H.R. Conf. Rep. No. 100-1104, (TAMRA ’88) *reprinted in* 1988-3 CB 596.) In a private ruling, the IRS has taken the position that a life insurance contract received in a Section 1035 exchange for a life insurance contract issued before June 21, 1988, will be considered as issued and entered into on the date that it is received in exchange for the previous contract and, thus, apparently be subject to the seven pay test. Let. Rul. 9044022.

# Life Insurance Policies – Loans

Policy loans under life insurance policies and endowment contracts (which are not modified endowment contracts) are not treated as distributions. IRC Secs. 72(e), 7702(7)(B)(iii).

However, if a loan is still outstanding when a policy is surrendered or allowed to lapse, the borrowed amount becomes taxable at that time to the extent the cash value exceeds the owner’s basis in the contract, as if the borrowed amount were actually received at the time of surrender or lapse and used to pay off the loan. (If a policy loan is outstanding at the time of a Code section 1035 tax-free exchange, the amount of the net reduction in the taxpayer’s outstanding loan will be considered as “boot” and taxable as ordinary income at that time to the extent there is income on the contract.)

If a loan is outstanding at the time of death, the distribution of the face amount of the policy will be reduced by the amount of the outstanding loan. Proceeds received on account of the death of the insured are generally tax-free. However, the benefit of tax-free death proceeds in excess of cost may be lost in the case of a policy transferred for value.