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# *Untaxingly Yours*

## *A Practical Guide to Life Insurance—Part I: Understanding Terminology and Uses*

By Brian T. Whitlock

As both a practicing attorney and a practicing Certified Public Accountant working in the areas of business succession and wealth transfer, I am probably the last person that anyone should look to for guidance on life insurance. Nevertheless, in 45 years of practice, I have picked up a few things that I think are important for practitioners to know about life insurance products and some of the tax implications involved in tax planning involving insurance policies.

In this, which is the first of two columns, we will explore the world of life insurance, some of the common terminology, and some of the marketing strategies that underlie insurance contracts.

In Part II of this column, we will explore the income and estate tax aspects of life insurance, including some traps for the unwary in terms of how the contracts are structured and owned and where the benefits are intended to flow.

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## Definition of Life Insurance

Life insurance is a legally binding contract between the insurer (typically a life insurance company) and the policy owner to pay a death benefit to the beneficiary named by the policy owner when the insured person dies, provided the policy owner has paid the insurer all the premiums called for in the contract.[1]

## Income and Estate Taxation of Insurance Death Benefits

Under Code Sec. 101(a)(1), the proceeds of life insurance, paid by reason of the death of the insured, are generally excluded from the gross income of the beneficiary. Under Code Sec. 264(a)(1), the premiums paid on life insurance contracts are generally not income tax deductible if they are paid by a person who is either directly or indirectly a beneficiary under the policy. Under Code Sec. 2042, a decedent's gross estate includes any death benefit received by the decedent's estate as well as any proceeds received by other beneficiaries where the decedent possessed any "incidents of ownership" in such policy at the time of death.[2]



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## Income Taxation of Viatical "Lifetime" Settlements

Accelerated death benefits received during the lifetime of the insured may also be excluded from taxable gross income under Code Sec. 101(g), if the insured is terminally ill or chronically ill, and if the benefits are paid to the insured. If the benefits are paid to any person other than the insured (*i.e.*, someone who has an insurable interest) such as an employer, then the accelerated benefits are included in gross income under Code Sec. 101(g)(5).

## Insurable Interest

In order to purchase a life insurance policy on the life of another person, the owner of the policy must generally have an insurable interest in the life of the insured person. Insurers are suspicious of attempts to purchase life insurance policies on the lives of strangers.

Life insurance companies will frequently limit the maximum amount of death benefit that can be purchased on the life of an individual being insured to the person's net worth or some multiple of the insured's stream of income that the owner or beneficiary of the policy is seeking to replace in the event of the insured's death. In order to prevent employers from purchasing large contracts of life insurance on employees and thus exhausting the maximum amount of insurance that the employee could purchase for the protection of his own family, Congress imposed limitations on employer-owned life insurance, sometimes referred to as company-owned life insurance (COLI). Under Code Sec. 101(j), the death benefit proceeds of COLI will be taxable to the employer if they fail to give adequate notice to the employee at the time that the life insurance policy is purchased by the company.

## Contestability Period

Many insurance contracts contain language that allow the insurer to deny death benefits if the insured dies within the first two years of purchasing the contract. This conditional period of time is referred to as the "contestability period." This language also typically provides that the insurer may contest the payment of benefits in the event of suicide, a serious unreported health condition, or misrepresentations made on the application for insurance coverage.

One of the questions on the insurance application specifically seeks to disclose whether the policy will be owned or if it is intended to be sold to an unrelated third party. This "stranger-owned life insurance" (STOLI) is frowned upon by insurers because STOLI policies generally disrupt the pricing mechanisms that insurance companies use to determine premiums. Insurance companies frequently assume (and thus build into their pricing model) that some portion of their regular policy holders will ultimately get tired of paying premiums because of events that occur in their lifetimes. For example, some people may inherit wealth from a relative, they may get divorced, they may get a new job that provides a life insurance alternative. These changes in circumstances may lead the policy holder to the allow the old policy to lapse, without the insurance company ever having to pay a benefit. Third-party investors, on the other hand, rarely allow a policy to lapse. The result is that it skews the actuarial assumptions that impact the premiums that the insurer intends to charge for the coverage. The insurance industry actively lobbies both the federal and state legislatures. As a result, a number of states have enacted laws that prohibit STOLI transactions.

## Types of Life Insurance

There are basically two types of life insurance: "Term Life Insurance" and "Permanent Life Insurance". There are numerous variables that factor into the cost of life insurance. Insurance companies do not freely share either the expenses or the formulas that they use in computing their costs for various policies and thus the setting of the underlying premiums. As a result, practitioners will frequently refer to life insurance as a "black box" that we are not allowed to see into and are left to guess the underlying factors that the actuaries consider in determining premiums. This lack of transparency makes it difficult to compare the similar life insurance policies offered by different companies.

## The Cost of Insurance

The cost of life insurance is based on numerous personal actuarial factors. The most likely factors that influence the cost of life insurance premiums are those that make up the "mortality charges," which are influenced by:

- Age (the older we are, the more likely we are to die);
- Health (poor health makes death more likely), a physical examination by a licensed medical professional is frequently required;
- Family medical history (cancer, heart conditions, and genetic anomalies contribute to premature death);
- Gender (women, on average, generally live longer than men);
- Occupation and lifestyle (dangerous jobs and hobbies, *e.g.*, flying, skydiving, mountain climbing all add to the risk of accidental death);

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- Automobile driving history (speeding and moving violations increase the risk of accidental death); and
- Personal habits (smoking and use of recreational drugs limit life expectancy).

In addition, the cost of insurance will also be based upon "expenses" that consist of numerous business factors, which are reflected in the internal costs of business operations within the insurer, and its profitability goals.

The final factor influencing the cost of insurance is "policy persistence." This factor consists of the likelihood that the policy owner will continue to pay premiums. The technical name for this factor is the "lapse ratio," which is the percentage of policies that will lapse (*i.e.*, terminate) before the death of the insured, thus permitting the insurance company to keep all of the earlier premiums without ever paying a claim on the policy.

## Term Life Insurance

Term life insurance is a year-to-year bet between the policy owner and the insurer. The policy owner pays the premium; if the insured dies, the insurer pays the benefit. If the insured is still alive after the end of the year, the insurer wins the bet and keeps the initial premium. There is no residual value, and in the second year, the policy owner pays a second premium.

In theory, the health and the age of the insured will determine the amount of the term insurance premium. The older the insured is and the worse the insured's health is, the higher the premium (cost) should be, because the risk of death gets higher each year.

There are some additional features that can be added to a traditional term life insurance contract. These features are typically contained in "Riders," which can be added to the policy for an additional charge.

- *Convertible Term*—The policy may permit policy owners the ability to convert the existing term policy into a permanent policy.
- *Renewable Term*—The insurer commits to a schedule of premiums that cannot change if the health of the insured declines.
- *Level Term*—The insurer agrees to lock in a constant premium for 10 or more years. The early premiums are higher than in a traditional term policy, but the premiums in the later years are below the premiums generally due on a traditional term policy. Despite the fact that the premium is greater than the typical term premium, the additional amount paid is not an asset of the policyholder; the investment risk lies solely on the insurance company.

## Permanent Life Insurance

Permanent life insurance is, in essence, a term policy with a "side fund" attached. If this variety of permanent life insurance meets the definition of life insurance under Code Sec. 7702, then the side fund may earn income and accumulate value on a tax-deferred basis. This accumulated side fund may then be used to defray the cost of the term insurance tax-free as the risk of death (and cost of the underlying term insurance) rises.

Code Sec. 7702 defines what is, in essence, a permanent life insurance contract as any contract under United States or foreign law that meets either (1) the cash value accumulation test or (2) the guideline premium or cash value corridor test. Contracts failing to meet the Internal Revenue Code definition are treated as term insurance together with a currently taxable deposit fund.

The variety of permanent insurance policies continues to change over time as the investment environment changes. The marketing names associated with such policies vary from insurer to insurer, but the basic philosophies underlying how the side fund is created and invested are similar. In essence, the policyholder pays a premium that is greater than the cost of traditional term insurance. This excess premium is an asset of the policyholder and it accumulates as a "side fund," which is used to offset some or all of the future costs of the life insurance. The risk of performance on this side fund lies with the policyholder. If the side fund performs better than projections, then the amount of premiums that the policy owner will pay in the future may be reduced or even eliminated. If the side fund performs worse than projections, then what the policy owner will be forced to pay in future premiums will rise and may ultimately force the policy owner to consider allowing the policy to lapse. In some circumstances, the insurer may make certain limited guarantees of performance or fix a portion of the costs associated with the underlying insurance, but the ultimate risk remains with the policy owner.

Historically, there have been two types of permanent insurance: "Whole Life Insurance" and a broader group that I will refer to as "Term Side Fund Insurance."

## Whole Life Insurance

For decades, there were only two types of life insurance "Term" and "Whole Life." Prior to the 1970s when interest rates were relatively low, insurance companies could safely invest the premiums that they collected for Whole Life in long-term bonds. The returns on the long-term bonds were predictable 20 and 30 years into the future. The insurance companies could therefore make promises to

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policyholders in terms of guarantees. Whole Life Insurance contracts typically offer:

- Fixed premiums for the life of the insured,
- Fixed death benefits, and
- Guaranteed increases in the cash value associated with the policy.

The cash value associated with Whole Life is largely a misnomer. It generally represents the amount that the policy owner could receive if the policy was surrendered during the lifetime of the insured, but it does not increase the death benefit.

The relative cost of Whole Life is significantly higher than the cost of ordinary Term insurance. As a sales and marketing strategy, insurers will often encourage their agents to "blend" or mix in Term insurance with Whole Life in an effort to lower the cost of premiums throughout the life of the contract. Years later, when the children are out of college and the home mortgage is paid off (*i.e.*, the need for insurance diminishes), the Term portion of the contract (which is now expensive) can be discontinued.

## Term Side Fund Insurance

The insurance industry has always employed a number of very creative marketing professionals. As the investment landscape has changed over the last 50 years, traditional investment philosophies have changed. In the 1950s and 1960s, investors typically limited their investment portfolios to stock and bonds. Interest rates were consistently low (under 3%). Bonds were a safe investment, and therefore, permanent insurance consisted exclusively of Whole Life contracts.

In the 1970s and early 1980s, oil prices increased dramatically as the countries of Middle East took control of the oil fields and created the Organization of Oil Exporting Countries (OPEC). Increases in commodity prices and wages followed, and world investment markets were faced with higher interest rates. Bonds and fixed-interest investments fell out of favor and were replaced by short-term interest-bearing investments. The 1990s and early 2000s saw a lowering of interest rates and larger investment returns in the stock market associated with stocks and bonds. Increases in the Dow Jones, Standard and Poor's, NASDAQ, and other broad-based indices led to the proliferation of Indexed Mutual Funds, and the last 15 years have seen the creation of Exchange Traded Funds (ETFs), hedge funds, and investments in Private Equity. As markets have changed, the insurance industry has changed to chase those same investable dollars by offering "insurance" meeting the definition of the Internal Revenue Code of Term life insurance with a side fund attached.

- *Universal Life Insurance (UL)*—the side fund here is typically invested in short-term interest-bearing investments. They performed well in the 1980s and 1990s, but they have suffered as interest rates have fallen. Many of these policies lapsed or failed under the strain of poor performance.
- *Universal Variable Life Insurance (VUL)*—the side fund here is typically invested in mutual funds typically created and managed by the insurance companies that offered the insurance products being sold. These funds have had years of good performance, but they are typically burdened with high loads (*i.e.*, commissions and fees) and internal charges. As a variation on this theme some insurers have moved away from proprietary funds and have allow policyholders to invest in third-party mutual funds.
- *Indexed Universal Life Insurance (IUL)*—the side fund here is typically invested in mutual funds based on various indices. They are frequently managed by firms outside of the insurance industry.
- *Private Placement Life Insurance (PPLI)*—the side fund here is typically invested in a wide-array investment options, including private companies, hedge funds, real estate funds, commodities, and currencies. It is offered largely without formal securities registration. Typically, this PPLI has involved only large investors willing to commit more than $1 million per year in the form of premiums and willing to work with offshore insurance companies (frequently based in Europe and the Caribbean). PPLI has been criticized by some as a "loop-hole" in as much as it attempts to wrap private investments inside of "life insurance" in order to obtain the tax-deferred accumulation of income that insurance offers under Code Sec. 7702.

## Variations on the Theme

The marketing minds at the insurance companies are always at work attempting to distinguish their company and their products from the competition. As a result, they will frequently introduce variations to their permanent insurance portfolio of products.

- Single Premium Whole Life (SPWL), as its name implies, SPWL involves a large upfront premium payment that can be permitted to grow income tax-deferred and thus meet the future cost of insurance without the need for additional insurance premiums. Code Sec. 7702A classifies life insurance contracts that fail to pay at least seven premiums as Modified Endowment Contracts (MECs). In order to discourage the use of a MEC as a type of tax shelter, cash

withdrawn either as a loan or a distribution from a MEC is treated as income first and a recovery of cost basis only after all income is stripped out.

- Guaranteed Universal Life (GUL) is effectively the opposite of SPWL. In a GUL contract, the policy owner forgoes any value that may be accumulating in the side fund in exchange for a guaranteed premium schedule and a guaranteed death benefit typically to age 120 years. The premium schedule is not only guaranteed (*i.e.*, it will not increase) but is also fixed (*i.e.*, inflexible). Typically, most insurance contracts allow a 30-day grace period for the payment of premiums that protects the policyholder from a lapse in the contract. GUL offers no such grace period. If the premium is not timely paid, various guaranteed aspects of the policy (typically the age to which the death benefit is guaranteed, or the amount of the death benefit) will begin to be reduced by the insurer.
- Joint Life (Second to Die) (JL) offers the policy owner the opportunity to purchase a single contract of insurance on more than one life at the same time. JL contracts have been issued on either a First-to-Die or a Second-to-Die (Survivorship) basis depending upon the need.[3] Only one death benefit is paid. Purchasing a single insurance policy on two lives can be less expensive than purchasing a separate policy on each life. A JL policy can be structured as any one of the previously discussed Term or Permanent contracts.

## Common Permanent Policy Riders

Permanent policies will also offer "bells and whistles" that might make the policy more attractive.

Disability Rider—Rather than purchase a separate disability insurance policy that will pay a benefit if a person is permanently disabled, in exchange for an increased premium an insurer will cover the cost of future life insurance premiums of the insured in the event of a disability.

Long-Term Care (LTC) Rider—Rather than purchase a separate policy to cover the costs of long-term care either at home or in a nursing home, a LTC rider can allow the insured to access the side fund at either no cost or a lower interest rate. Although we will all die someday, not everyone will need long-term care. Standalone LTC insurance policies, therefore, can be difficult to market. A policy with a LTC rider is often referred to as a "Hybrid" since it offers some of the features of both types of coverage.

## Why Life Insurance?

There are a host of reasons that individuals and businesses seek to own life insurance. Primarily, the decision is driven by the need to have funds available at the death of an individual. Some may see life insurance as a forced savings that will provide their family with the ability to pay for a funeral. Others with dependents may wish to replace earnings or an income stream that may be lost as a result of death. Homeowners with mortgage debt consider life insurance as a means of paying off a mortgage that might be an overwhelming burden on a surviving spouse or domestic partner. Young parents consider life insurance as a means of providing for the support and education of their families. Business owners may see life insurance as a forced savings vehicle that will provide funds that will enable the buy-out of each of the owners to a business enterprise. The reasons for buy life insurance are as diverse as one can image.

## Why Is this Discussion About Life Insurance Important?

At some point, as either consumers or advisors, we will be a party to a conversation involving a life insurance salesperson. At that time, we will need to be conversant in some of the rudimentary terms, concepts, and principles underlying life insurance. Regardless of all the marketing hype that is published which seeks to applaud the tax-deferred investment advantages of life insurance, at its core, we should always remember that in the end it is really about the death benefit; the other stuff is just fluff.

### ENDNOTES

1 Amy Fontinelle, *Life Insurance: What It Is, How it Works, and How to Buy a Policy, www.Investopedia.com/terms/l/lifeinsurance.asp* (updated September 21, 2023).

2 Incidents of ownership generally include (1) the right to change the beneficiary of the policy; (2) the right to borrow any cash value accumulating inside of the insurance policy; and (3) the value of any reversionary interest in either the policy or the proceeds that exceeds 5% of the value of the policy immediately before death.

3 First to Die coverage is typically purchased for income replacement for a younger family where both spouses are working in an effort to support the household. Second to Die coverage sometimes called "Survivorship Life Insurance" is typically purchased to provide liquidity for estate and inheritance taxes or to fund for the special needs of a disabled child after both parents have passed away.

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