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Taxation of Distributions

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The rules governing the tax treatment of distributions from life insurance or annuity contracts are complex. Worse, the relevant IRC section, section 72, seems at times to be the product of a conspiracy in restraint of understanding. Unfamiliar phrases (e.g. "income on the contract," and "investment in the contract") serve to further make the subject hard to approach. This article will be one actuary's attempt to shed some light on the subject.

Let's start with those phrases. Most actuaries who deal with policyholder tax matters use the word "basis," but section 72 calls it "investment in the contract." Similarly, we laypeople tend to use the word "gain" where section 72 opts for "income on the contract." Just knowing this much helps one to penetrate the section 72 fog.

In general, distributions are taxed in three ways. The first approach is the first in, first out (FIFO) approach and is thought of as the friendly approach, since it defers tax. Under this approach, basis is distributed first, and no distributed amount is taxable until all basis is gone. The second approach is last in, first out (LIFO) and it does the reverse of FIFO. Under LIFO, gain is distributed first, and no distributed amount is free of tax until all gain is gone from the contract. Finally, the third (pro-rata) approach compromises between these two extremes and views any distribution as a mix of taxable gain and basis in the same proportion as existed in the contract just before the distribution. (This pro-rata taxation applies to contracts under qualified plans under section 72(e)(8) and is beyond the scope of this article.) How distributions are characterized, i.e., as basis or gain, is the job of section 72.

Section 72 allocates any "amount received" by the policyholder under the contract between two categories: income on the contract (gain) or investment in the contract (basis). The sum of these two amounts equals the amount received. The portion allocated to gain is taxable to the recipient, while the amount allocated to basis reduces investment in the contract and is not taxable. To determine this allocation, we look to the definitions in section 72.

Investment in the contract as of any date is defined by section 72(e)(6) as the total amount of premium or other consideration paid for the contract before that date less the aggregate amount received by the policyholder from the contract before that date, to the extent the amount received was excluded from gross income for income tax purposes. (We will later see a modification to adjust for taxed policy loans, but that can wait.) Income on the contract is effectively defined in section 72(e)(3) as the excess of contract cash value before reduction for any surrender charge over the investment in the contract.

Allocation of distributions under section 72 is done one way for annuities and modified endowment contracts (MECs), and another way for non-MEC life insurance contracts. For non-MECs, section 72(e)(5) applies, and the amount received is allocated to income on the contract to the extent it exceeds investment in the contract at the time of distribution. That is, the FIFO method of taxing applies and basis is fully recovered before any income amount is recognized. Also, for a non-MEC, a policy loan is not treated as a distribution and does not create an amount received by the policyholder.

For an annuity or a MEC, section 72(e)(10) makes section 72(e)(2)(B) applicable, and the amount received is allocated to income on the contract to the extent it does not exceed the income on the contract at the time of distribution. That is, the amount received is taxable income first to the extent of gain, and only after all gain has been taxed is there any allocation to basis. This is the LIFO method of taxing distributions. However, we note that section 72(e)(5)(E) provides special treatment for full surrender of a contract, which creates an exception to the rule discussed so far in this paragraph. On full surrender, the amount received is included in gross income, but only to the extent it exceeds investment in the contract—the FIFO rule. This rule allows full basis recovery for annuities and MECs in circumstances where there is a full surrender in the presence of a surrender charge. (Suppose a MEC with basis $800 and gain $200,

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hence cash value $1000, is surrendered. Assume a $100 surrender charge applies. Without this special rule, income on the contract of $200 would be LIFO taxed, and of the $900 amount received, only $700 would represent basis recovery. The surrender rule prevents this.) Finally, for annuities and MECs, policy loans are treated as distributions and create an amount received by the policyholder (section 72(e)(4)(A)). This applies to loans taken to pay policy loan interest as well as to loans taken as cash or to pay premiums.

Policy dividends are given special treatment. A dividend or similar amount that is retained by the insurer as a premium or consideration for the contract is not treated as a distribution and does not create an amount received due to section 72(e)(4)(B). Policy dividends also do not have any effect on investment in the contract (basis). This favorable treatment is not extended to partial surrenders or policy loans applied to pay premiums. Thus, partial surrenders or policy loans create distributions for a MEC or an annuity, which may well be fully or partly taxable. Similarly, a dividend applied to reduce a policy loan is treated as a distribution for both MECs and non-MECs. These distributions reduce basis only to the extent they are not taxable.

The taxing of policy loans from MECs and annuity contracts requires an adjustment to basis accomplished by the final sentence of section 72(e)(4)(A). The policy loan does not affect the cash value of the contract and neither will any repayment of the loan. Any taxed portion of the loan is, however, added to the investment in the contract (basis). If a policy loan is applied to pay premium, the basis is increased by any taxed portion of the loan and further increased by the amount applied as premium (just as any premium payment increases basis).

Finally, we should note that under section 72, the investment in the contract is not always the same as section 7702(f)(1) premiums paid. Three differences come to mind. The first occurs when a contract is issued as an exchange, in which gain is not recognized due to the operation of section 1035. Under section 7702, the entire amount of exchange money counts as premiums paid. However, section 1031(d) intervenes to create a carry-over basis from the old contract to the new one. The effect of this carry-over is to treat income on the old contract, not taxed in the exchange, as income on the new contract. For completeness we note that if the policyholder in a section 1035 exchange receives money (boot), in addition to a new contract, the money is taxable to the extent there is gain in the old contract and any excess of the boot over the prior contract gain will reduce the carry-over basis of the new contract. (section 1031(b) and Reg. Section 1031(d)-1(b)).

The second way basis can differ from premiums paid is through the taxation of policy loans from MECs. As previously noted above, the taxed portion of the loan increases investment in the contract (basis), but there is no effect on premiums paid.

The third difference is created by a special rule in section 7702(f)(1)(B) allowing amounts taxable under the force-out rule of section 7702(f)(7)(B), (E) to reduce premiums paid under section 7702. This does not mean that these amounts reduce section 72 investment in the contract. We note that the same treatment could have been explicitly given to amounts distributed from a MEC under the 60-day rule of section 7702(f)(1)(B) and treated as taxable under section 72, but the opportunity to do it right seems to have been missed. My suspicion is that there are companies with guideline premium tested contracts taking the position that an amount can be premium returned under section 7702 regardless of its treatment under section 72. (Actuaries can be so literal minded; lawyers have a way of characterizing a thing as a mouse for some purposes and an elephant for others.) Those taking this position would allow an amount distributed from a MEC to reduce premiums paid under section 7702 even if the amount was fully taxable under the MEC rules. If this becomes a matter of interest at your company, consult the company tax attorney to establish a company position.

You should be aware that section 72 does other things we have not discussed. In particular, it imposes additional tax (penalty tax) on certain distributions from MECs and annuities (see section 72(q) and (v)) and provides for taxation of annuities in the payout stage. It also deals with some aspects of the taxation of qualified plans.

TABLE 1
SUMMARY OF TAXATION OF DISTRIBUTIONS UNDER IRC SECTION 72

	TIMING OF TAX	POLICY LOANS	PENALTY TAX
NON-MEC LIFE INSURANCE	FIFO	NOT TAXED	NONE
MECs	LIFO	TAXED WITH BASIS ADJUSTMENT	10% WITH EXCEPTIONS
ANNUITY	LIFO	TAXED WITH BASIS ADJUSTMENT	10% WITH EXCEPTIONS