



Article from

Taxing Times

October 2017

Volume 13, Issue 3

Tracking the Flow of Money in a Life Insurance Policy to Compute Cost Basis and Distributions

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I am an information technology professional with over 25 years of experience designing and building life insurance policy taxation systems with many life insurance companies. Over the years I have worked with product tax actuaries and tax attorneys in this pursuit. In this article I discuss how including the intent and rationale of the tax law when translating the law into specifications for coding tax systems can improve the system design, reduce system complexity, and achieve flexibility and maintainability.

This article will illustrate the approach by introducing the concept of tracking the “flow of money” in a life insurance policy when processing policy level transactions. Analyzing the flow of money in a policy provides a method for calculating cost basis and determining distributions from the policy.

BACKGROUND

As John Adney discussed in the June 2017 issue of *TAXING TIMES*, “investment in the contract” and “basis” are fundamental concepts to the taxation of life insurance products. These values are essential in determining if there is a tax liability due to a specific transaction on a life insurance policy. Calculating and maintaining an accurate cost basis for a policy is one of the most important tax processing functions in the administration of a life insurance policy. The policy’s cost basis directly affects whether a distribution from the policy’s investment in the contract is taxable to the policy owner.

In my experience, the best approach for computing cost basis for the administration of a life insurance policy is to establish a separate data field for tracking cost basis that is stored with the other policy values, rather than attempt to derive it when needed from other values available for the policy.¹ There are many different situations when processing transactions for a policy that can occur that impact cost basis. It would be onerous to try to recreate all of these events at a later point if deriving cost basis from other values. For each transaction



processed for the policy, the running total for cost basis is adjusted (up, down or no change) based on the impact that transaction has on the cost basis. Cost basis can be impacted by many different types of policy transactions, including premium payments, withdrawals, partial surrenders, monthiversaries, and dividends.²

If a distribution subject to taxation occurs for a policy and an amount is deemed taxable, then a 1099-R tax form is used to report the taxable distribution to the policy owner.³ Box 1 provides the gross distribution, Box 2a is the taxable amount, and Box 5 is used for the “employee contributions,” *i.e.*, cost basis. For example, a \$25,000 (Box 1) withdrawal from a non-MEC life insurance policy where the cash value was \$60,000 and cost basis was \$20,000 (Box 5) would result in a taxable amount of \$5,000 (Box 2a).

The calculations behind the scenes to arrive at these figures are often quite complicated and require the utmost accuracy. Like most life insurance policy taxation system business requirements, the “devil is in the details.”

INTENT OF THE LAW

When writing business specifications for tax system processing, it is helpful to understand and document the intent and rationale behind sections of the tax law in specifications and to focus on “what” processing is required—instead of “how” the processing is to be performed. Including this information in the business specifications facilitates the development of appropriate design solutions and allows system developers to construct solutions in a more flexible manner.

I worked with a product actuary who often said that he tried “not to lead the programmer” in his specifications. He did not want to provide the detailed method for coding the system. Rather, the software professionals trained in various design techniques could utilize different approaches while working with the specification author to achieve the desired system result. Detailed technical specifications would identify “how” the system would accomplish the processing. Modern computer languages provide various capabilities to facilitate modeling insurance policies and their components that simplify coding.

As an example, consider the intent of the reduction in benefit testing requirement, in Internal Revenue Code section 7702A(c)(2)(A). The intent of this rule is to prevent a policyholder from purchasing a policy with high benefit amounts in order to set a high 7-pay premium limit, then depositing money up to the limit, and then sometime later reducing the policy benefits to make it more affordable. The requirement to retest as if the lower level of benefits were present since the beginning of the 7-pay testing period is challenging for a policy administration system which processes transactions chronologically.

There are a variety of possible system solutions that could be considered to achieve this requirement in a system (including manual intervention) and I have seen several of them in practice. Some solutions are much more difficult to implement than others. Identifying the intent of the law and describing what processing is required encourages consideration of design alternatives that provide the best overall solution.

Regarding “investment in the contract,” the tax law is concerned with how much money has been contributed to the investment in the contract and the current value of those contributions in the policy, *i.e.* cost basis. Distributions from the contract are evaluated for taxation based on the policy’s gain, cost basis, and taxation method (*e.g.*, gain first, cost recovery first, etc.).

The tax law does not speak to a specific insurance company’s products or detailed product designs like specific riders, benefits, features, or dividend options. An insurance company’s detailed tax interpretation must consider the company’s product designs and policy features in formulating system specifications. While it is tempting to write explicit specifications for system development referencing how to handle all of the products and product complexities in scope, this can lead to very complex system coding with considerable redundant logic, onerous testing requirements, and a brittle system.

As an alternative, consider a more general approach when developing business specifications. Include the intent and rationale of the tax law and author rules more at the conceptual level. Also, provide detailed examples that are helpful for demonstrating calculations.

To illustrate, when considering the rationale behind how a life insurance policy is taxed, analysis leads to identifying four section 72(e) categories for interpreting components of a life insurance policy, as shown in Table 1.

Table 1

Section 72(e) Category	Description	Possible Policy Components ⁴
Investment in the Contract	Considered part of the tax law’s “investment in the contract”	The base policy, investment accounts ⁵
Inside the Contract	Recognized by the tax law as part of the policy, but not part of the investment in the contract	Specific type(s) of riders, benefits, or features
Outside the Contract	Considered outside the contract for tax law purposes, but may be administered with the contract for the convenience of the policyholder	Specific type(s) of riders, benefits, or features, dividend accumulation account, an outstanding policy loan ⁶
Outside the Company	Money that leaves the policy and insurance company	A check mailed to the policy owner

As transactions are applied to the policy, the flow of money is tracked between the components of a policy and key tax values are updated appropriately. The “flow of money” in and out of the investment in the contract is essentially what matters to the tax law. The business specifications for the system can be written in a more general, conceptual manner. For example:

- Money flowing to components of the policy considered Investment in the Contract would be included in cost basis. That is, cost basis would be increased by money flowing into these components.⁷
- Money flowing out of Investment in the Contract components to Outside the Contract or Outside the Company components would, in general, be considered a distribution subject to possible taxation. This could result in a taxable amount and/or reduction in cost basis.⁸
- Money flowing to the other section 72(e) categories would not increase cost basis and flows out would not be distributions.
- Money flowing within the components considered Investment in the Contract would not be a distribution or have any impact on cost basis. For example, an exchange from one

investment account option to another investment account option or a dividend earned by the base policy used to purchase paid up additions would not result in a distribution subject to taxation or cost basis update.

Also included in the specifications would be a list of all policy components where each component would be identified with the section 72(e) category that applies for that component. For example, the base policy would be identified as Investment in the Contract, the dividend accumulation account would be Outside the Contract, etc. This information can be designed to be included in a separate data file that is readable by the tax system which allows for easy update.

Designing and coding the system in a more general way avoids a lot of transaction specific tax logic.⁹ Table 2 provides a list of specific policy transaction activity and how the general tax processing logic would handle it.

It should be noted that a similar approach of arriving at categories for components of a policy would apply to other areas of the tax law as well. For example for section 7702A, components of a policy could be classified as a TAMRA Death

Table 2

Policy Transaction Activity ¹⁰	Money Flow	Tax Processing
Payment of a normal premium by payor	From Outside the Company to Investment in the Contract	Increase cost basis
Withdrawal from policy’s investment account with check to policy owner	From Investment in the Contract to Outside the Company	Distribution subject to taxation, Cost basis reduced and/or taxable amount
Dividend paid with check to policy owner	From Investment in the Contract to Outside the Company	Distribution subject to taxation, Cost basis reduced and/or taxable amount
Dividend paid to accumulation account	From Investment in the Contract to Outside the Contract	Same as dividend paid with check above
Dividend paid for loan interest	From Investment in the Contract to Outside the Contract	Same as dividend paid with check above
Surrender of dividend accumulation account with check to owner	From Outside the Contract to Outside the Company	No additional tax impact (the tax impact was recorded when the dividends were applied) ¹¹
Premium payment made from dividend accumulation account	From Outside the Contract to Investment in the Contract	Increase cost basis
Monthiversary	Charges deducted from the Investment in the Contract to pay for benefits Outside the Contract	Distribution subject to taxation, Cost basis reduced and/or taxable amount
An exchange from one investment account option to another	From Investment in the Contract to Investment in the Contract	No impact ¹²

Benefit, Qualified Additional Benefit, etc., and specifications would be written accordingly.

EXAMPLE

To illustrate how the detailed calculations are performed at the system level, consider an example from dividend paying life insurance. Policies that pay a dividend have certain dividend options that define how the dividend is to be applied. Dividend options often include the following type of options:

- Reduce the policy premium
- Pay in cash
- Accumulate at interest
- Purchase paid up insurance
- Pay loan interest

In addition, many complex dividend options exist that combine several of the primitive options above—for example, Reduce Premium, then Pay (the remainder in) Cash.

Applying the flow of money concept for a policy level transaction that applies a \$100 dividend earned from the base policy to the dividend accumulation account yields the results seen in Table 3.

This results in a distribution subject to taxation of \$100 that leads to either a reduction in cost basis and/or taxable gain amount.¹³

Consider a more complex, contrived example, where a “super” dividend option is in effect on a policy and a policy level transaction applies the \$100 dividend earned from the base policy and \$10 dividend earned on paid up insurance from dividends. The \$110 total dividend is applied as follows: \$50 to reduce the premium, \$25 to buy paid up insurance, \$20 to pay loan



interest, and \$15 to accumulate at interest. This would be handled by the system as seen in Table 4.

In this example, the Investment in the Contract sees a reduction of \$110 from paying the dividend. This is offset by \$75 reinvestment in components that are also considered Investment in the Contract. The result is a net distribution of \$35 which would either reduce the policy’s cost basis and/or be treated as a taxable gain amount depending on the cost basis, cash value, and taxation method in effect for the policy.

Table 3

Policy Component	Section 72(e) Category	Outflow	Inflow	Impact on Investment in the Contract
Base policy	Investment in the Contract	-100		-100
Dividend accumulation account	Outside the Contract		+100	0
Net distribution				-100

Table 4

Policy Component	Section 72(e) Category	Outflow	Inflow	Impact on Investment in the Contract
Base policy	Investment in the Contract	-100	+50	-50
Paid up insurance from dividends	Investment in the Contract	-10	+25	+15
Loan interest	Outside the Contract		+20	0
Dividend accumulation account	Outside the Contract		+15	0
Net distribution				-35

In the examples above the calculations are performed without any specific references to particular dividend options, that is, there is no IF THEN rule stating “IF Dividend Option 1 applies THEN do this...” Alternatively, the calculation is performed by detecting where the money flows after the transaction is applied to the policy. Avoiding direct references to detailed product specifics (like dividend option types) reduces system complexity and improves maintainability.

As mentioned earlier, the same concept can be applied to other tax related calculations like tracking money that is included in the guideline premium test (guideline premiums paid) and 7-pay test (amounts paid).

CONCLUSION

The tax law applicable to life insurance policies has underlying intentions and rationale. It is written without any specifics of particular insurance policy designs. An insurance company’s interpretation of the tax law takes into account the company’s

products. Including the intent and rationale of the tax law in business specifications and focusing on what the system must do, rather than how to do it, enables more robust system designs. This leads to less complex coding and testing, and the system will be more resilient to change.

Disclaimer: The information contained herein is provided for informational purposes only and not for purposes of providing any professional advice. Applicability of the information to particular situations should be determined by your tax advisor. ■

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ENDNOTES

- 1 Separate policy level data fields are also recommended for other running totals of money like “amounts paid” (section 7702A) and “guideline premiums paid” (section 7702), since some of the rules for accumulating these values differ from cost basis.
- 2 Some additional scenarios where specific types of transactions can impact the cost basis of a policy include:
 - a. loan or loan capitalization transactions where the new loan includes a distribution subject to tax (due to the policy being a MEC)
 - b. lapse transactions for policies with outstanding loans where the policy value supporting the loan amount is treated as a distribution and taxed accordingly
 - c. policy change transactions where money is disbursed or if the policy becomes a MEC when processing the transaction and the two-year look back results in the need to determine a tax liability for a prior transaction
 - d. surrender transactions for policies with an outstanding loan or 1035 exchange surrender transactions for policies with an outstanding loan or recent prior distributions
- 3 Normal taxable distributions are reported with a distribution code = 7. Other distribution codes are used to report other activity like early distributions, 1035 exchanges, or Long Term Care rider charges, for example. Form 1099-R and the related instructions are available at irs.gov.
- 4 Examples of possible interpretations for policy components are provided to help illustrate the concepts, not for purposes of providing any professional advice. As John Adney noted in the June 2017 issue of *TAXING TIMES*, the manner of treatment of benefit riders for section 72 is a subject worthy of additional discussion. An insurance company’s classification of their various benefit riders would be stated in the company’s tax specifications.
- 5 Investment accounts, as used in this article, refer to the separate account(s) maintained for the policy for the investment of the policy values. Various investment accounts may be created in the administration of the policy (e.g., the cash value of a universal life policy or a loan collateral account when a policy has an outstanding loan). The investment account for a variable life policy may contain a number of investment account options (sub accounts) which are elected by the policy owner.
- 6 The term “loan” can be considered both a verb and noun. A loan transaction performs the action of borrowing money (the verb) which results in an increase in the outstanding loan liability amount (the noun). Normally taking a new loan is not considered a distribution, but it is a distribution for policies that are MECs. The outstanding loan liability that results from a loan transaction is considered Outside the Contract in that actions performed for servicing the loan like the payment of loan interest or loan payments to reduce the loan amount are considered Outside the Contract.
- 7 In practice, there are some exceptions to these general rules. For example, payments from incoming 1035 exchanges will provide a carryover cost basis from the previous policy.
- 8 There are a variety of rules that determine if a distribution subject to taxation is taxable including whether the policy is in a gain situation, the policy’s MEC status, the current cost basis, etc. Some riders receive special treatment.
- 9 In general, I recommend that the majority of the tax processing system logic should not be directly tied to transactions. The tax law is largely transaction agnostic. For instance, in section 7702A(c)(2)(A), the tax law states that “if there is a reduction in benefits under the contract within the 1st 7 contract years...,” however, the tax law does not stipulate what type of policy transaction may have caused that reduction in benefits to occur. Many insurance policy administration systems have separate transaction processing modules that contain detailed processing logic for handling each type of transaction. Building specific tax logic within the transaction modules can reduce flexibility.
- 10 Policy transaction activity examples are representative of transactions that occur on a variety of types of life insurance policies (e.g., whole life, universal life, variable life, etc.).
- 11 The interest credited to the dividend accumulation account is taxable and reportable when paid.
- 12 Some transactions may result in no tax impact, but that does not suggest skipping the transaction entirely in tax processing. Rather, a transaction can still be processed for tax testing that nets to zero in some tax calculation. Opting to skip administrative transactions for tax processing can lead to problems later when the law or interpretation changes occur that require processing that type of transaction.
- 13 In general, cost basis is reduced by any non-taxable distributions. For system processing consistency, I prefer a three-step method to arrive at the updated cost basis. First, determine the distribution subject to taxation. Second, determine the taxable amount (if any) based on the policy’s cost basis, MEC status, etc. Third, adjust the cost basis down by the distribution amount and up by the taxable amount. In this example, the investment in the contract may end up remaining the same if the entire distribution is taxable.