ADVANCED UNDERWRITING CONSULTANTS
TOGETHER WITH ALICS
www.ALICSonline.com

LIFE LIVE

A MONTHLY NEWSLETTER FROM ADVANCED UNDERWRITING CONSULTANTS

November 2011

Tax FAQ about Chronic Illness Riders on Life Insurance Policies

Many life insurance companies have developed riders for their life insurance contracts that permit an acceleration of the policy's death benefit if the insured is chronically ill.

Here are some of the frequently asked tax questions about that kind of rider.

Question: One of my clients is thinking about buying a life insurance policy that has an accelerated death benefit feature for chronic illness. Would the benefits paid under such a rider be income tax free?

Answer: Usually yes. It's impossible to give a definitive general answer because the provisions of the rider and the condition of the insured at the time of claim may affect the result. Also, if the policy is owned by someone other than the insured, the benefit may NOT be tax free. This concern also potentially applies when the spouse of the insured is the owner of the policy.

Section 101 of the Internal Revenue Code says that life insurance death proceeds are usually income tax free. Section 101(g) goes on to say that life insurance benefits paid will be treated like tax-free death proceeds if paid to a chronically ill insured.

The same subsection goes on to define *chronic illness* in the same way that it's defined under qualified long-term care-contracts. Many riders are designed to be triggered by the insured's being unable to do two activities of daily living (ADLs), or when the insured has severe cognitive impairment. That's consistent with the definition of *chronic illness* under qualified long-term-care contracts.

If the life contract has a qualifying chronic-illness rider, it seems clear that the benefits are tax free when paid to the insured up to $300/day in 2011, or actual long-term-care expenses if greater.

Question: I am recommending key-person life insurance on one of the owners of a company. The policy has a chronic-illness rider. What are the tax consequences of exercising the rider?

Answer: Section 101(g) of the Internal Revenue Code says that accelerated death benefits are tax free, up to the limits described above, if paid to a chronically ill insured.

However, if the benefits under a chronic-illness rider are paid to a *business*, Code Section 101(g)(5) says that the special rule, treating the chronic-illness benefit as a tax-free death benefit, does not apply.

Therefore, it appears that amounts paid under the rider to a business will be taxed under normal life insurance taxation rules when they are received by the business. That means, under a non-MEC policy, amounts received up to basis will be a tax-free return of basis, and any additional amounts will be taxable when paid to the business.

Question: One of my clients is thinking about buying a life insurance policy that has an accelerated death benefit feature for chronic illness. The client also wants the insurance to be excludible from his taxable estate through ownership by an irrevocable life insurance trust (ILIT). How can I help make that work?

Answer: If there's a choice, it's probably not a good idea to combine ILIT ownership of a policy when the insured wants to access the chronic illness rider.

Where the insured is the owner of the contract, it seems clear that the benefits are tax free when paid to the chronically ill insured up to $300/day in 2011, or actual long-term-care expenses if greater.

To be effective for estate-tax reasons, an irrevocable trust must not permit the insured to have any right to the assets in the trust. If

Contact AUC at:
615.224.1291

Lawrence J. Owens
JD, CLU, ChFC, MBA, FLMI

Linas Sudzius
JD, CLU, ChFC

Gaylord Gardner
JD

Gweyn Colaberdino
JD

Matt Cottingham
JD

Tax FAQ about Chronic Illness Riders on Life Insurance Policies (Continued)

the trustee is permitted to make lifetime chronic-illness distributions to the insured, or for the insured's benefit, it puts the estate-tax effectiveness of the ILIT at risk.

It is possible to use one or more of the trust beneficiaries–including spouse, if desired–as potential conduits for chronic-illness payments back to the insured. This has two important drawbacks:

- first, nothing can be agreed in advance that the beneficiary is under any obligation to access money for the insured, and
- second, the benefit paid may be taxable.

If the chronic illness accelerated benefit is payable to an ILIT, the IRS hasn't said for sure that the benefit is tax free. Some experts believe that if the ILIT is treated as a grantor trust–that is, the insured is treated as the trust's owner for income tax purposes–the benefit *should* be income tax free. We will continue to wait for clarification from the IRS.

In general, because of the potential for family uncertainty or estate-tax risk, we don't recommend that anyone who wants to use the chronic-illness rider put the life insurance in an irrevocable trust.

Business Insurance Table

This chart is for agent use only, and may not be used with consumers. Tax information is general only and may not be relied on in specific situations.

The chart row referring to “Cash Values” assumes that the underlying cash-value life insurance policy is not a modified endowment contract (MEC). Lifetime distributions from MEC contracts are taxed less favorably under current federal income tax rules than distributions under non-MEC life contracts. The row also assumes that the policy owner takes withdrawals from the contract up to cost basis and loans thereafter and that the contract stays in force until death.

Life insurance death benefits are normally federal income tax free. There are certain exceptions to the general rule, including, but not limited to:

- violation of the transfer for value rule,
- failure to comply with the requirements of Code Section 101(j),
- naming a personal beneficiary for a business-owned policy.

	Executive Bonus Plan	Split Dollar Plan	Supplemental Executive Retirement Plan	Key-Employee Life Insurance Plan
DESCRIPTION	The employer pays an employee extra to cover the cost for needed personal life insurance.	The employer and the employee share the premiums for and benefits of personal life insurance.	The employer pays a deferred benefit to an employee as agreed upon by both parties.	Indemnifies business for loss of skills and experience of key employee.
USES	Reward a key employee. Provide funding for a cross-purchase buy-sell plan.	The company can recover the costs of helping an employee buy needed life insurance. Can be used for cross-purchase buy-sell funding	Induces employees to stay until retirement. The employer may keep part of the death benefit for key person needs. Can be configured for the employer to recover costs.	Provides dollars to help train a replacement plus replace lost profit. Useful to help guarantee business debt. Can be used for redemption buy-sell funding.
ADVANTAGES	The employer chooses the amount of bonus and who participates. The employer gets a tax deduction for the bonus.	The employer chooses the employees to be included, the amount of benefit, and the tax regime of the plan. The plan can be configured to recover the employer's costs.	The employer may pick employees to be covered and benefits to be paid. The benefits are not directly tied to the insurance policy. The employer gets to use the policy and its values.	Provides replacement dollars to keep the business going, through the usual income tax-free death benefit.
DISADVANTAGES	The bonus is taxable income for the employee. The employer loses control of the policy and its cash values.	Administration of the plan takes some work. The employer gets no tax deductions for the plan.	Administration of the plan takes some work. Benefits subject to the resources of the business. Benefits are income taxable when received as income by the employee or the beneficiary.	Premium payments are not income tax deductible.
CONTRIBUTIONS DEDUCTIBLE?	Yes. IRC Sec. 162.	No. IRC Sec. 264.	No. IRC Sec. 264.	No. IRC. Sec. 264.
POLICY OWNER	The employee	The employer or employee, depending on the regime.	The employer	The employer
PREMIUM PAYER	The employer, by means of bonus to employee.	The employer and employee may share premiums.	The employer	The employer
BENEFICIARY	The employee names his or her own beneficiary.	The employee names his or her own beneficiary. The employer is the beneficiary of its portion.	The employer	The employer
TAXATION OF DEATH BENEFIT	Proceeds are generally received free of federal income tax.	Proceeds are generally received free of federal income tax.	Proceeds are generally received free of federal income tax.	Proceeds are generally received free of federal income tax.
CASH VALUES	Cash values accumulate tax deferred and may generate tax-free supplemental retirement benefits.	Cash values accumulate tax deferred and may generate tax-free supplemental retirement income.	Cash values generally accumulate tax deferred, are a business asset, and may generate tax-free cash.	Cash values generally accumulate tax deferred, and can be used to informally fund the employer's obligation to pay the employee retirement income.
LEGAL AGREEMENT NEEDED?	Recommended, especially for restricted bonus plan.	Yes.	Yes.	Yes, for Section 101(j) compliance purposes.
COMMON VARIATIONS	Single Bonus Plan Double Bonus Plan Restricted Bonus Plan	Loan Regime Economic Benefit Regime Third-Party Ownership Private Split Dollar	Death Benefit Only Plan Section 457(f) Plan	None.
MAKES SENSE FOR OWNER-EMPLOYEE?	Not usually for tax purposes but can be done for convenience.	May make sense in limited circumstances, especially to control gift tax costs where they are an issue.	Not usually for tax purposes unless the business is in a much lower income-tax bracket than the owner-employee.	Yes.

ADVANCED
UNDERWRITING CONSULTANTS
TOGETHER WITH ALICS

370 Mallory Station Road
Suite 521
Franklin, TN 37067

Think About It...

"A Monthly Tax and Technical Publication for Financial Professionals"

Think About It is written by Linas Sudzius

Do you enjoy reading Life Live every month? Consider subscribing to **Think About It!**

Linas Sudzius offers his current thinking on the latest life insurance and financial tools, techniques, and cutting edge planning concepts. He tells it like he sees it - month after month.

Think About It is available for individual subscribers or can be licensed for re-distribution by your organization.

To request a sample issue, or for subscription information,
call Lisa at 615.224.1291, or visit **www.advancedunderwriting.com**.