



## Federal Income Taxation of Accelerated Benefit Riders

Since the Health Insurance Portability and Accountability ACT (HIPAA) was signed into law on August 21, 1996, increasing numbers of health-related insurance products and riders have appeared in the marketplace. This in turn has generated widespread confusion as to their income tax treatment. This paper is intended to provide guidance with respect to some of the most frequently asked questions regarding the federal income taxation of Accelerated Benefit Riders (ABRs), sometimes called Living Benefit Riders.

### The World of Accelerated Benefits

Currently, there are three types of ABR issued by the National Life Group companies: ABR for Terminal Illness, ABR for Chronic Illness, and ABR for Critical Illness.

ABR Terminal will pay a discounted accelerated death benefit when the insured is has been diagnosed with a terminal illness that is expected to result in death within two years. ABR Chronic will pay a discounted accelerated death benefit when the insured is unable to perform at least two of six Activities of Daily Living or suffers from a severe Cognitive Impairment for a period of at least 90 consecutive days. ABR Critical will pay a discounted accelerated death benefit when the insured suffers from one of the following conditions: Heart Attack, Stroke, Cancer, End Stage Renal Failure, Major Organ Transplant, ALS (Lou Gehrig's Disease), or Blindness.

### Federal Income Tax Treatment for ABR Terminal and Chronic Illness

Section 101(a)(1) of the Internal Revenue Code (the "Code") – the authority for the income tax-free treatment of life insurance death benefits – states this general rule: "gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." Section 101(g)(1)(a) of the Code sets forth another general rule: that any amount received as accelerated death benefits under a terminal illness ABR rider "shall be treated as an amount paid by reason of the death of the insured." This means that accelerated death benefits for terminal illness are generally treated as having the same income tax exclusion as is accorded to benefits paid at the actual death of the insured.

### Exceptions

Of course it would not be the Internal Revenue Code if there were not exceptions. The first exception is where the policy has been transferred for a valuable consideration (the Transfer for Value Rule) and none of the exemptions provided in Section 101(a)(2) are applicable. In other words, if the death benefits would have been taxable at the death of the insured, then amounts received under ABR Terminal Illness while the insured is still alive will be subject to the same treatment.

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### Example

Assume that Wilma is the original and current owner and beneficiary of a \$500,000 term life insurance policy on Fred. If Fred becomes terminally ill, Wilma can exercise the ABR Terminal Illness Rider and receive income-tax free benefits. If Wilma has previously gifted the policy to Pebbles, and Pebbles becomes the owner and beneficiary, then Pebbles can exercise the rider and receive income tax-free benefits. However, if Wilma sold the policy to Pebbles for its fair market value three years earlier, that would constitute a transfer for a valuable consideration, and all death benefits (accelerated or otherwise) received by Pebbles, less what she paid for the policy (sale price plus ongoing premiums) would be includible in her income.

### Section 101(g)(5) creates another exception for business-related policies.

“This subsection shall not apply in the case of any amount paid to any taxpayer other than the insured if **such taxpayer has an insurable interest with respect to the life of the insured by reason of the insured being a director, officer, or employee of the taxpayer or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.**”

**“This subsection” refers to subsection (g) of Section 101; subsection (g) contains the language that enables ABR benefits to enjoy an income tax exclusion. Thus, the effect of this provision is to make the accelerated benefits includible in the beneficiary’s income.**

### Example

Mavis Frisbee is the Managing Partner and chief rainmaker of Ben, Jarvis, Green & Ellis, PC, a very successful mid-sized Boston law firm. The firm has purchased a \$2 million key person insurance policy on Mavis, and is the owner and beneficiary. Assuming that the firm has complied with the Employer-Owned Life Insurance rules (including the annual filing of IRS Form 8925), if Mavis dies the firm will collect \$2 million of life insurance death benefits income tax-free. However, there will be a different result if Mavis becomes terminally or chronically ill: **because the firm’s insurable interest in Mavis is based on her being an employee of the firm, exercise of ABR Terminal or Chronic Illness will NOT allow the firm to exclude the accelerated benefits from income.**

### Example

A-Rod and K-Rod, well-known professional athletes, are business partners in a thriving chain of bowling alleys. They enter into a cross-purchase buy-sell agreement, with each owning a \$5 million life insurance contract on the other. If K-Rod becomes terminally or chronically ill, A-Rod would not be able to collect income tax-free accelerated benefits under ABR Terminal or Chronic, because **A-Rod’s insurable interest in K-Rod is based on the insured (K-Rod) being financially interested in a trade or business carried on by the taxpayer (A-Rod).**

**On the other hand**, A-Rod could potentially transfer the contract to K-Rod, using its fair market value as a partial payment for K-Rod’s ownership interest in the business.<sup>1</sup> K-Rod could then exercise the rider and receive income tax-free benefits.

### Special Rules for ABR Chronic

To qualify for the income tax exclusion, accelerated benefits riders must comply with a variety of rules, most of which are referenced or contained in Code Sections 101 and 7702B. These include requirements that benefits paid under the riders must be either:

1. For costs incurred by the recipient for qualified long-term care services provided to the insured and not compensated for by insurance or otherwise, or
2. Made on a per diem (\$310 per day/\$113,150 annual per diem in 2012) or other periodic basis within limitations established by the Internal Revenue Service.

Payments made under ABR Chronic attached to a **National Life Insurance Company policy** are limited by the per diem amounts described in (2) above, as well as by the discounted death benefits payable under the rider, and thus should generally qualify for the income tax exclusion.

Payments made under ABR Chronic attached to a **Life Insurance Company of the Southwest policy** are limited to a maximum of 2% of the discounted death benefit payable monthly. If these amounts exceed the per diem limit described above, they enjoy an income tax exclusion only to the extent that they reimburse the recipient for costs described in (1) above.

<sup>1</sup> To the extent that the fair market value of the policy exceeds cost basis, A-Rod may have to recognize the gain.

## Federal Income Tax Treatment for ABR Critical Illness

The tax treatment of accelerated benefits for Critical Illness is somewhat less clear and significantly more complicated than the treatment of benefits for terminal or chronic illness. Since neither Section 101 nor 7702B make any mention of critical illness benefits, we have to look in other areas of the Code to find answers.

The only pronouncements we have to date on this issue are four Private Letter Rulings issued by the IRS since the turn of the 21st century. And while PLRs cannot be relied on by anyone other than the recipient as authority, they can provide a strong indication of how the IRS regards an issue and what position it would take on the subject. In this line of PLRs, the IRS' reasoning has been very consistent.

**PLR 200339015** and **200339016** are virtually identical, having been written on the same day by the same IRS technical reviewer. In each case, a Critical Illness Rider was attached to a universal life policy and paid for by extra charges imposed against the policy cash value. In these cases, the Critical Illness benefit did NOT represent an acceleration of death benefits, and would not reduce the death benefit paid under the base policy. The Riders did not have any cash value.

In **PLR 200627014**, a Critical Illness Rider was attached to a term contract. The Rider would pay a lump sum of up to \$250,000 (reduced by 50% at age 65) in the event the insured suffered from any one or more of a list of critical illnesses. Again, the Rider had no Cash Value. In this case, the term policy death benefit WOULD be reduced by any benefits paid under the Rider.

Most recently (2009) the Service issued **PLR 200903001** in response to a ruling request submitted by an insurance carrier. In this case, a Critical Illness Rider was to be attached to an "individual, non-participating, flexible premium adjustable life insurance policy." The Rider, which has no cash value, pays a benefit if the insured is diagnosed by a physician as having a qualifying covered condition; any benefit paid reduces the death benefit under the base policy, which terminates if the death benefit is reduced to zero.

Among the more significant representations made by the carrier were the following:

"Taxpayer represents that the Contract and Rider are purchased with after-tax monies, i.e., no premiums are deductible by the owner or attributable to contributions by an employer of an owner which were not includible in the gross income of the owner. Thus, **the Contract and Rider are purchased solely with the owner's after-tax funds.**"

In each of these cases, the Service Ruled that the Critical Illness **benefits would be received income tax-free**, and in all cases virtually the same legal analysis was applied: **the coverage provided by the Critical Illness Rider is treated as accident or health insurance under Code Section 104(a)(3).**

Under Section 104(a)(3) gross income does not include "**amounts received through accident or health insurance** (or through an arrangement having the effect of accident or health insurance) **for personal injuries or sickness,**" so long as these amounts received are

- NOT attributable to contributions by the insured's employer which were not includible in the employee's gross income, or
- NOT received directly from the employer

Both of the 2003 PLRs as well as the 2006 ruling also point to Section 105 of the Code. Section 105(b) provides an income tax exclusion for benefits received for personal injuries or sickness under accident or health insurance plans, to the extent that the insured does not take medical expense deductions for expenses covered by the insurance benefits. Section 105(c) provides an exclusion for amounts received as compensation "for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement" of the insured, so long as the benefits are computed based on the nature of the condition and not on the period of absence from work. The exclusions under subsections (b) and (c) are available regardless of whether the insurance was paid for in whole or in part by employer contributions that were not includible in the employee's income.

### Example

Mavis owns a life insurance contract on her own life on which she pays premiums with her own after-tax dollars. If she receives accelerated benefits for Critical Illness, they should be income tax-free.

## Example

Mavis owns the same life insurance contract on her own life on which her employer pays premiums under an Executive Bonus Plan. Because the premiums are includible in her income, any Critical Illness accelerated benefits she receives under the contract should be income tax-free.

## Example

The law firm still owns that \$2 million key person contract on Mavis (see above). When Mavis suffers a heart attack, the firm accelerates benefits under ABR Critical and pays them directly to Mavis **to reimburse her for medical expenses**. Since the premiums were not includible in her gross income, AND since she's receiving the benefits from her employer anyway, Section 104(a)(3) would appear to require the amounts she receives to be includible in her income. **However, the exclusion appears to be saved by Section 105(b), so long as the amounts received by Mavis are limited to reimbursements for medical expenses paid by her for which she has not claimed income tax deductions.**

Although there is no specific rule about business-related policies in connection with Critical Illness accelerated benefits, **it is likely that the firm must include the accelerated benefits in its income**, since the law seems to be written with an intent to compensate insureds for injuries or sickness. The firm should receive an offsetting deduction under Section 162 (ordinary and necessary business expenses) for the amounts paid to reimburse Mavis for her medical expenses.

## Example

The firm decides to set up a Section 79 plan in which Mavis is a participant. Mavis has her heart attack during the five-year funding period when the policy is still connected with the plan. It is unclear whether or not the ABR Critical benefits are "attributable to contributions by the employer which were not includible in the employee's gross income," since Mavis had to include in gross income the value of both the insurance protection and the permanent benefit. On the other hand, the amount she had to include was less than the amount the firm contributed. Even if all or part of the benefits are deemed to be attributable to employer contributions that were not included in her income, so long as the benefits are limited to an amount necessary to reimburse her for nondeductible medical expenses they should be received income tax-free.

## Bottom Line

It appears as though, in most cases, accelerated benefits received under an ABR Critical Illness Rider will be treated as amounts received under accident or health insurance, and thus will not be included in the recipient's taxable income. However, where the recipient of the accelerated benefits is anyone other than the insured or a person with respect to whom the insured is a spouse or legal dependent, there is substantial doubt as to whether the benefits will be entitled to an income tax exclusion.

Example: Back to A-Rod and K-Rod (see above). K-Rod develops a critical illness, and A-Rod wants him out. If A-Rod accelerates benefits under ABR Critical Illness, it is likely that the benefits will be includible in A-Rod's income, since the law seems to be written with an intent to compensate insureds for injuries or sickness – not to fund business buyouts.

As described earlier, A-Rod could potentially transfer the contract to K-Rod, using its fair market value as a partial payment for K-Rod's ownership interest in the business. K-Rod could then exercise the rider and receive income tax-free benefits.

## Life Insurance in Qualified Retirement Plans

Accelerated Benefit Riders may be added to life insurance contracts in a Profit Sharing Plan. However, there is substantial uncertainty as to the federal income tax treatment of distributions under any of the ABRs.

- In the case of a permanent policy with cash value, distributions under ABR Terminal or Chronic could be characterized as a pro rata distribution of death benefit and cash value. To the extent the cash value portion exceeded the participant's cost basis, that portion could then be taxable. And if the participant were an unincorporated business owner, there would be no offset for cost basis in the contract.
- In the same situation, distributions under ABR Critical might be treated differently: although the carrier treats these amounts as accelerated death benefits, the IRS appears to treat these distributions as amounts received under accident or health insurance. Of course, the same uncertainty arises if the acceleration results in a reduction of cash value; AND it would appear that the distributions would have to be limited to reimbursements for related medical expenses anyway to retain the income tax exclusion, if it were otherwise available.

- The bigger question that arises is whether under the plan provisions there is even a distributable event: Typically, a distributable event would include death, total and permanent disability, separation from service, or plan termination.

For these reasons, the more predictable approach would be to distribute the policy to the participant – assuming a distributable event has occurred – and have the participant accelerate benefits after it has become an individually owned policy.

### Example

The firm has had a qualified Profit Sharing Plan in place for many years. Mavis has elected to use some of her account balance to purchase a life insurance policy. When Mavis suffers her heart attack – assuming it triggers a distributable event – the plan trustee distributes the policy to Mavis. Although she must include in income the fair market value of the policy in excess of her basis in the policy (cumulative taxable term costs), when she exercises ABR Critical the benefits should be income tax-free, at least to the extent that they reimburse her for related expenses for which she does not take a medical expense deduction.

## Practical Considerations – Federal Income Tax Reporting

From a practical standpoint, the IRS requires insurance carriers to report ABR Chronic and Terminal accelerated benefits on a Form 1099-LTC. Although the guidance is not crystal clear on this point, National Life Group carriers will report ABR Critical accelerated benefits on a Form 1099-R. Note that the form contains no place for the carrier to indicate whether these distributions are taxable or not. **It is the responsibility of individual or business taxpayers (typically policy owners and beneficiaries) to consult their professional tax and legal advisors and report accordingly on their tax returns.**

In those situations where an employer is the policy owner and uses accelerated benefits to reimburse the insured employee for qualifying expenses, the carrier reports with respect to the employer and the employer must report with respect to distributions it makes to the employee.

## Income Taxation of Premiums

The National Life Group ABR Riders do not require premium payments. Thus, there are no issues regarding either the deductibility of premiums by the premium payor or the inclusion of premium amounts by the policy owner.

### Summary

Most benefits received under **ABR Terminal or Chronic** should be income tax-free, provided that:

- Death benefits under the contract would have been received income tax-free in the event of the death of the insured, and
- The recipient of the benefits has an insurable interest in the insured that is NOT based primarily on a business relationship.

Most benefits received under **ABR Critical** should be income tax-free, provided that:

- They are received by the insured, or by a person with respect to whom the insured is a spouse or legal dependent, as beneficiary.

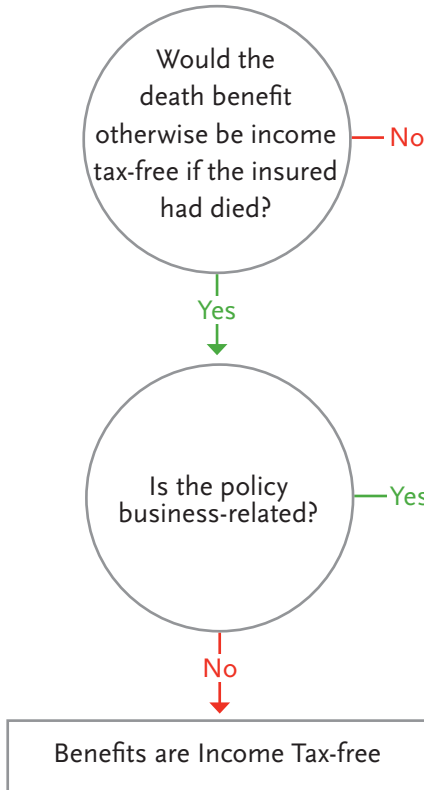
**However**, the income tax exclusion is limited to amounts necessary to reimburse the insured for expenses paid by the insured and not deducted as medical expenses, if:

- The policy premiums were paid by the insured's employer and not includible in income by the insured, or
- The benefits are received by the insured directly from the employer.

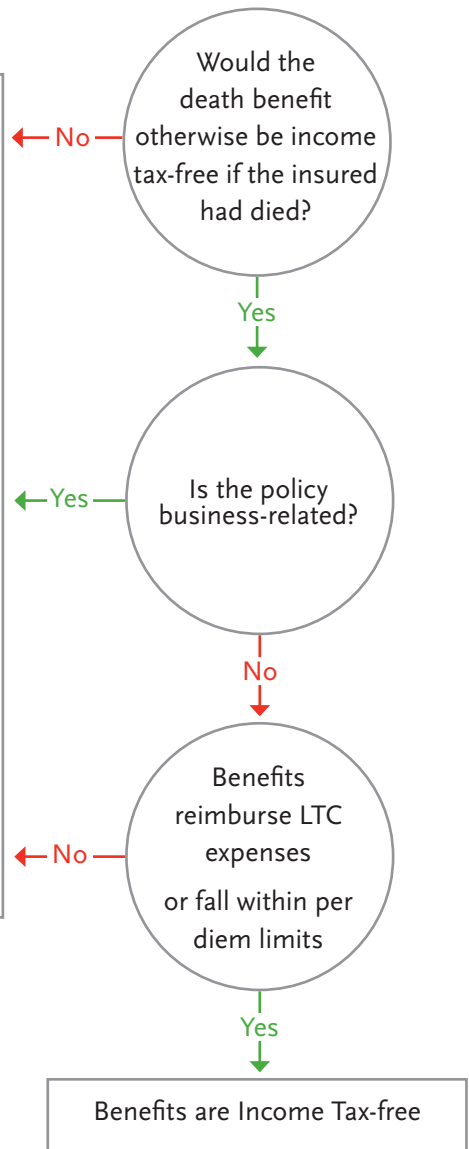
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<sup>2</sup> NL Group carriers are in the process of reviewing this practice to determine whether ABR Critical benefits are more properly reported on a 1099-R

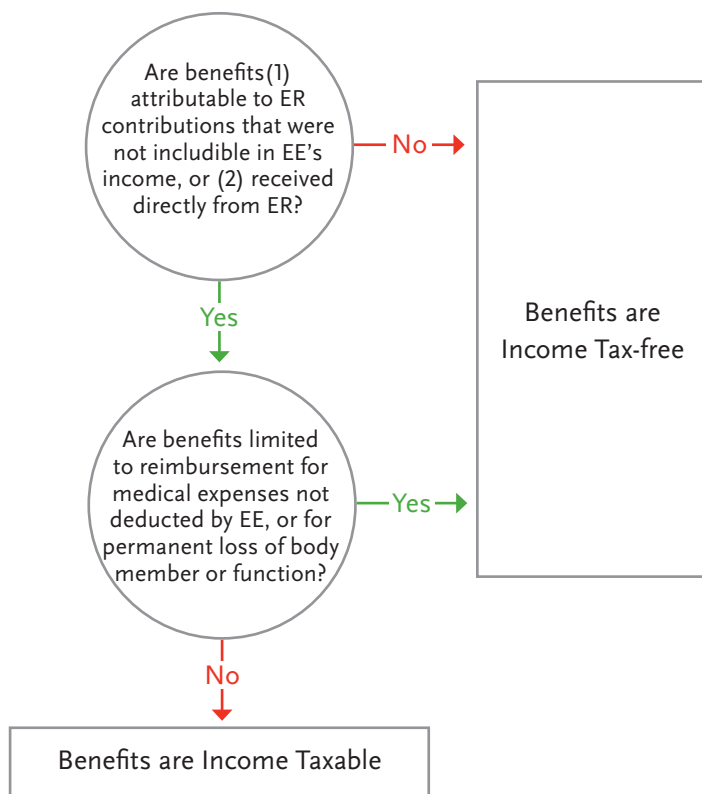
### ABR Terminal Illness



### ABR Chronic Illness



### ABR Critical Illness



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