

May 2011

Answers to Questions Frequently Asked to the Advanced Markets Group

Understanding the Basis and Recognition of Gain Rules Applicable to Transfers of Policies Encumbered by Policy Loans

The Advanced Markets Group is often asked questions about the federal income tax consequences of a contemplated transfer of a life insurance policy subject to an outstanding loan. Transfers can take many forms, such as a gift of a policy to a child, to an Irrevocable Life Insurance Trust (ILIT) or to a charitable organization.

A thorough analysis of the application of the rules controlling basis and gain recognition under the Internal Revenue Code should be undertaken before entering into any such transaction. These rules are complex and their application to a given transaction can be complicated. The following is an outline of the application of the basis and gain recognition rules to some commonly encountered situations. This outline provides a basic understanding of the application of the rules in such situations, but should not be substituted for a thorough analysis by the client's professional tax and legal advisors.

Section 1035 Exchanges

A §1035 exchange of a policy on which there is an associated outstanding policy loan¹ can be dealt with in one of two ways: either the policy loan can be carried over to the new policy; or the loan can be paid off at or prior to the 1035 exchange. If the loan is paid off from external funds (*i.e.*, the owner provides cash to repay the policy loan), there generally will be no adverse tax consequences. However, using policy values to pay off the loan may have adverse tax consequences, which are outlined below.

If the policy loan is carried over to the new policy, the owner of the policy will not recognize any income on the exchange (and therefore will not have to pay any income taxes). In other words, by carrying over the loan to the new policy, the owner defers the built-in gain of the old policy and carries over such gain to the new policy. To account for such deferral, the federal income tax basis of the new policy will be equal to the carry-over basis of the old policy plus the amount of any additional premium paid with respect to the new policy (but not including unrelated adjustments). This is illustrated in IRS regulations (see §1.1031(d)-2) and by the following example:

Assume that a policy has a gross cash surrender value of \$1,000, an outstanding loan balance of \$200 and a basis of \$700. Assume further that the policy is exchanged for a new policy and that the loan balance is carried over to the new policy. The amount of gain recognized and the basis of the new policy are calculated as follows:

| Gain Calculation: | |
|---|---------|
| Value of new policy received in the exchange | \$1,000 |
| Plus boot (cash or other property received in the exchange) | \$0 |
| Plus old policy loan value | \$200 |
| Total consideration received in the transfer | \$1,200 |
| Less basis of old policy | \$700 |
| Less new policy loan value | \$200 |
| Gain realized | \$300 |
| Gain deferred Under Section 1035 | \$300 |
| Basis Calculation: | |
| Basis of old policy | \$700 |
| Plus amount of new loan | \$200 |
| Less amount of old loan | \$200 |
| Plus amount of gain recognized | \$0 |
| Basis of new policy | \$700 |

If, however, the policy loan is paid off at the time of or within a short time before or after the exchange (and there is no legal authority for what constitutes a short time frame) the loan amount will be deemed to be boot received in the exchange and thus will not be eligible for deferral under Section 1035. Thus, gain will be recognized in an amount equal to the amount of the boot (*i.e.*, the payoff value of the loan). This result is illustrated as follows:

| Gain Calculation: | |
|--|------------------------------------|
| Value of new policy received in the exchange | \$800 |
| Plus boot (cash or other property deemed received in the exchange) | \$200 (loan payoff value) |
| Plus old policy loan value | \$0 |
| Total consideration received in the transfer | \$1000 |
| Less basis of old policy | \$700 |
| Less new policy loan value | \$0 |
| Gain realized | \$300 |
| Gain recognized | \$200 (up to amount of loan value) |
| Basis Calculation: | |
| Basis of old policy | \$700 |
| Less boot | \$200 |
| Plus amount of gain recognized | \$200 |
| Basis of new policy | \$700 |

If there is a sufficient time gap between repayment of the loan and the 1035 exchange, the payoff value of the loan will not be deemed boot and will have no effect on the tax-free nature of the 1035 exchange. Note, however, that if the policy loan is paid off through a partial surrender of the policy within the first fifteen years, there may be a recapture tax under Section 7702. This transaction, assuming a partial surrender with no recapture tax upon loan payoff, is illustrated as follows:

| Gain Calculation: | |
|--|---|
| Value of new policy received in the exchange | \$800 (\$,1000 CSV – \$200 amount of partial surrender) |
| Plus boot (cash or other property deemed received in the exchange) | \$0 |
| Plus old policy loan value | \$0 |
| Total consideration received in the transfer | \$800 |
| Less basis of old policy | \$500 |
| Less new policy loan value | \$0 |
| Gain realized | \$300 |
| Gain deferred under Section 1035 | \$300 |
| Basis Calculation: | |
| Basis of old policy | \$500 |
| Less boot | \$0 |
| Plus amount of gain recognized | \$0 |
| Basis of new policy | \$500 |

Gift of a Policy with an Outstanding Loan

What are the tax consequences of making a gift of a life insurance policy, if that policy is subject to a loan? The IRS treats a gift of a policy subject to an outstanding policy loan as a part sale/part gift transaction. The value of the loan is treated as consideration received from the donee (the “sale” portion). The net cash surrender value (or, more accurately, the “interpolated terminal reserve”) is deemed to be the “gift” portion. Because the donor is deemed to receive consideration in such a transaction, the donor must determine whether gain will be recognized as a result of the deemed sale.

What if the loan value is in excess of the donor’s basis in the contract? Generally, if the value of the loan on the date of the gift is less than the donor’s basis, the donor will not recognize any gain on the transfer of the policy. However, if the loan balance is greater than basis, gain will be recognized to the extent that the loan exceeds basis. The basis of the policy in the hands of the donee will be (i) the greater of (a) the amount deemed paid by the donee (the loan amount) or (b) the transferor’s adjusted basis for the property at the time of the transfer plus (ii) the amount, if any, of any increase authorized by the Code for gift taxes paid. (See Treasury Regulations, §1.1015-4.) The tax results of a gift of an encumbered policy are illustrated by the following example:

Assume that the policy's gross cash surrender value is \$1,000 with an outstanding loan of \$400 and a basis of \$600.

| Gain Calculation Situation I: | |
|--|---------------------|
| Amount deemed paid by the donee on the gift transfer | \$400 (loan amount) |
| Less donor's basis | \$600 |
| Gain realized by donor | \$0 (\$400-\$600) |
| Gain Recognized by donor | \$0 |
| Basis Calculation: | |
| (A) Donor's basis | \$600 |
| (B) Amount deemed paid by donee | \$400 |
| Greater of (A) and (B) | \$600 |
| Plus gift taxes paid by donor | \$0 |
| Basis of policy in the hands of donee | \$600 |

This time, assume that the policy's gross cash surrender value is \$1,000, the loan is \$800 and the basis is \$600.

| Gain Calculation Situation II: | |
|--|---------------------|
| Amount deemed paid by the donee on the gift transfer | \$800 (loan amount) |
| Less donor's basis | \$600 |
| Gain realized by donor | \$200 |
| Gain recognized by donor | \$200 |
| Basis Calculation: | |
| (A) Donor's basis | \$600 |
| (B) Amount deemed paid by donee | \$800 |
| Greater of (A) and (B) | \$800 |
| Plus gift taxes Paid by donor | \$0 |
| Basis of policy in the hands of donee | \$800 |

Will the gift of a policy subject to a loan trigger a transfer for value? Possibly. There are several exceptions to the transfer-for-value rule provided under §101(a), one of which is known as the "carry-over basis exception". Under the carry-over basis exception, if the basis the transferee (donee) takes in the contract is determined in whole or in part with reference to the basis the contract had in the hands of the transferor (donor) then there is no transfer for value.

The potential transfer for value comes from §1.1015-4, which states that, in the case of a part gift/part sale, such as a gift of life insurance with an outstanding loan, the basis in the hands of the donee would be determined by reference to how much the donee is deemed to have paid for the policy (*i.e.*, the amount of the loan) and not with reference to the donor's basis. Because the donee's basis is not determined by reference to donor's basis, the carry-over basis exception of §101(a) does not apply to this gift of the policy. (See PLR 891056).

This means that where the loan is not in excess of basis there is no transfer for value. But, when the loan exceeds the basis in the contract, the part sale/part gift rule applies to cause a transfer for value. If the transfer for value is triggered then the amount of the death benefit in excess of the total amount paid for the contract, including any gain recognized upon transfer of the contract, is subject to ordinary income taxes. In order to avoid the application of the transfer-for-value rules, there would have to be another exception to the transfer-for-value rule available to the donor and the donee.

Does it make a difference if the policy is given to an ILIT rather than to an individual? Possibly. If the gift is to an ILIT that is not a grantor trust for federal income tax purposes, then the ILIT is considered to be a separate taxable entity from the donor and the transaction gets the same tax treatment as the gift of a policy to an individual. However, if the ILIT is taxed as a grantor trust for federal income tax purposes, there should be no income tax effects to the grantor because a grantor generally cannot enter into a taxable transaction with himself. (See Rev. Rul. 85-13.)

Giving a policy with a loan in excess of basis to a defective grantor trust shouldn't trigger a transfer for value because the trust is a grantor trust. This is because Rev. Rul. 2007-13 says that transfers of a policy to a trust that is a grantor trust as to the insured are deemed to be transfers directly to the insured, which is one of the exceptions to the transfer-for-value rule.

What are the tax consequences of giving a policy with an outstanding loan to a charitable organization? A gift of a policy to a charitable organization may not generate a significant income tax deduction for the donor. This is because the value of the policy for income tax purposes will be limited to the donor's basis in the policy under §170(e) of the Code. If the policy is subject to an outstanding policy loan, then the transfer will be deemed to be a part sale/part gift transaction. As with gifts to non-charitable donees, the amount of the loan will be deemed to have been "paid" to the donor by the charity.

Then the donor must allocate his basis in the policy between the "sale" portion of the transaction and the "gift" portion of the transaction. Section 1.1011-2 requires that this basis allocation be done on a proportionate basis, dividing the basis based on the ratio between the loan value and the total value of the policy. As a result, the donor will always be deemed to have some amount of gain on the transfer and will recognize such gain accordingly. This gain will be offset against any income tax charitable deduction provided by the transfer. However, it is generally only the amount of the "part gift" to the charity that generates the charitable deduction, which can significantly limit the donor's overall available deduction for the charitable contribution.

The following example illustrates the application of the part sale/part gift rules to a charitable donation of a policy encumbered by a loan.

Assume that the policy's gross cash surrender value is \$1,000, the loan is \$800 and the basis is \$600.

This means that the loan is 80% of the overall \$1,000 value of the policy, resulting in an allocation of \$480 of basis (or 80% of the total basis) to the part sale portion (the loan) and \$120 (or 20% of the total basis) of the basis allocated to the part gift portion (the \$200 of policy value not subject to a loan).

The sale portion of the contribution will result in gain of \$320 to the transferor (the \$800 loan less \$480 of basis), and the charitable deduction will be limited to the donor's basis in the gifted amount, which is \$120. Depending on the donor's income tax bracket, the \$120 charitable deduction might not be sufficient to cover the income tax due on the \$320 of gain resulting from the "partial sale" of the contract.

1. For further discussion of Section 1035 exchanges in general, see our separate Because You Asked on the topic.

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The potential policy cash value of a life insurance policy grows on a tax-deferred basis. As long as the policy is not designed as a Modified Endowment Contract (MEC), you can take tax-free withdrawals and loans from the cash value. Withdrawals from the policy are income tax free up to the policy's cost basis (premiums paid), after which point you would take distributions as policy loans, which are generally not taxable.

Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Please consult your tax advisor for guidelines specific to your situation.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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MLINY06031115051

