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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

Often times the Advanced Markets Group is asked questions about the federal income tax consequences of a contemplated transfer of a life insurance policy subject to an outstanding loan. Such contemplated transfers can take many forms, such as: a 1035 exchange, a gift of a policy to a child or ILIT, or a gift of a policy to a charitable organization.

Before any such transaction is consummated, a thorough analysis of the application of the basis and gain recognition rules under the Internal Revenue Code should be undertaken. 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 counsel.

Section 1035 Exchanges

A section 1035 exchange of a policy that has an associated outstanding policy loan can be dealt with in one of two ways: the policy loan can be carried over to the new policy (John Hancock is one of the few life insurance companies that allows carry-overs of policy loans); 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. 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	1000
Plus boot (cash or other property received in the exchange)	0
Plus old policy loan value	200
Total consideration received in the transfer	1200
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 of 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 to a Child or an ILIT

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 (technically ITR) 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. 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. If, however, the loan balance is greater than basis, gain will be recognized. 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 and (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.

Note, however, that the immediately preceding analysis assumes that if the gift is to an ILIT, the ILIT is not a grantor trust for federal income tax purposes. If the ILIT were 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.) Note also that the IRS has suggested that there may be a transfer for value problem if a policy subject to an outstanding policy loan is transferred to a non-grantor ILIT and the amount of the policy loan exceeds the donor’s basis. It appears to be the position of the IRS that under Treasury Regulations, §1.1015-4 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. Thus, the exception to the transfer for value rule for gift transfers under Section 101 of the Code would not be applicable and a transfer for value would be deemed to occur upon the transfer of the policy to the ILIT. (See PLR 891056).

Assume the same facts as above except in Situation I the loan amount is \$200 and in Situation II the loan amount is \$800. The results are illustrated as follows:

Gain Calculation Situation I:	
Amount deemed paid by the donee on the gift transfer	200 (loan amount)
Less donor's basis	700
Gain realized by Donor	0 (200-700)
Gain Recognized by Donor	0
Basis Calculation:	
(A) Donor's basis	700
(B) Amount deemed paid by donee	200
Greater of (A) and (B)	700
Plus gift taxes paid by Donor	0
Basis of policy in the hands of donee	700
Gain Calculation Situation II:	
Amount deemed paid by the donee on the gift transfer	800 (loan amount)
Less donor's basis	700
Gain realized by Donor	100
Gain recognized by Donor	100
Basis Calculation:	
(A) Donor's basis	700
(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

Gift of a Policy with an Outstanding Loan to a Charitable Organization

Donor's may contemplate transferring an insurance policy subject to an outstanding policy loan to a charitable organization. Generally, this is ill-advised. A gift of a policy to a charitable organization will 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 Section 170(e) of the Code. If the policy is subject to an outstanding policy loan, 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. Unlike with gifts to non-charitable beneficiaries, however, the donor must allocate his basis between the "sale" portion of the transaction and the "gift" portion of the transaction. This is done on a proportionate basis, where basis is allocated to each portion based on the ratio of that portion to the total value of the policy (see Treasury Regulations, §1.1011-2). 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. Generally, only the amount of the donor's adjusted basis allocable to the "gift" portion will be deemed to be "gifted" to the charity.

As this article illustrates, calculation of basis and gain on the transfer of an insurance policy subject to an outstanding policy loan is a complex and complicated undertaking. Experienced, professional tax counsel for the client should be relied on to undertake such calculations.

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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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