

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

What Every Financial Professional Needs to Know About Life Policy Accelerations

Michael W. Lagos,
CFP®
President

Jane M. Roberts
Director of Client
Services

Justin P. Boren, PHD
Chief Compliance
Officer

Samuel Escobar
Financial Advisor

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Traditionally, the owner of a permanent life insurance policy had one choice when he or she needed money for a health situation—surrender the policy and receive the cash value.

More than 30 years ago, some third-party companies began to offer the owners of policies on terminally ill insureds the ability to *viaticate* the policy. In such cases, the *viatical settlement* company would make an offer to the owner to purchase the policy for a substantial percentage of the policy's death benefit.

As the market for viatical settlements developed, variations appeared. Viatical settlement companies began to change into life settlement companies—offering to buy policies not only when the insured was in a terminal condition but also when the insured was chronically ill or otherwise impaired.

Life carriers likewise began to offer accelerated benefit options, effectively allowing policy-owners early access to the death benefit when the insured was determined to be terminally ill or chronically ill.

Congress and the president got involved with clearing up the tax treatment of certain kinds of accelerations for chronic and terminal illness when they enacted Revenue Code Section 101 (g), effective in 1997. Those new provisions effectively put the federal seal of approval on life policy accelerations.

In this issue, we will discuss some of the tax and practical issues related to life policy accelerations.

Regards,
Michael W. Lagos, CFP®

The Advisor's Bulletin is provided by LAGOS WEALTH ADVISORS AND LAGOS FINANCIAL & INSURANCE SERVICES, INC. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

What Every Financial Professional Needs to Know About

Life Policy Accelerations

Not every life insurance company offers an acceleration feature for chronic or terminal illness. Some opt for stand-alone long-term care insurance riders instead of allowing a chronically ill insured policyowner to access the death benefit early. In this article, we will not discuss stand-alone riders but will focus on the kinds of death benefit accelerations described in Section 101(g).

ACCELERATIONS

Section 101(g) of the Internal Revenue Code provides for special tax treatment of death benefit accelerations related to terminal illness or chronic illness. The provision treats most accelerations as income tax-free death benefits.

Tax Code

Revenue Code Section 101(a) says that the death benefit from a life insurance policy is generally income tax-free. Code Section 101(g) confirms that accelerations for terminal and chronic illness are likewise tax-free.

(g) TREATMENT OF CERTAIN ACCELERATED DEATH BENEFITS

... For purposes of this section, the following amounts shall be treated as an amount paid by reason of the death of an insured:

Any amount received under a life insurance contract on the life of an insured who is a terminally ill individual.

Any amount received under a life insurance contract on the life of an insured who is a chronically ill individual.

The tax code treats chronic or terminal illness accelerations as part of the contract's tax-free death benefit—not as a withdrawal or loan from the policy. As such, the benefit is still tax-free if

- the contract is a modified endowment contract (MEC) or
- the contract lapses before the insured's death.

Terminal Illness

Terminal illness for the purpose of Section 101(g) is defined as follows:

The term “terminally ill individual” means an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification.

Most insurance carriers that offer terminal illness acceleration of the death benefit closely match the definition above. In general, if the policyowner accelerates some or all of the death benefit due to terminal illness, the insurance company discounts the benefit due to the fact that proceeds are being accessed prior to death.

Chronic Illness

DEFINITION

Chronic illness for the purpose of Section 101(g) is defined as follows:

In general . . . [t]he term “chronically ill individual” means any individual who has been certified by a licensed health care practitioner as—

- being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity,
- having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described in clause (i), or
- requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

Such term shall not include any individual otherwise meeting the requirements of the preceding sentence unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements. . . .

[E]ach of the following is an activity of daily living:

- Eating.
- Toileting.
- Transferring.
- Bathing.
- Dressing.
- Continence.

Most insurance carriers that offer chronic illness acceleration of the death benefit closely match the definition above. In general, if the policy owner accelerates some or all the death benefit due to chronic illness, the insurance company discounts the benefit because proceeds are being accessed prior to death. The discounting is usually more substantial than that which applies to terminal illness.

LIMITS ON TAX-FREE BENEFITS FOR CHRONIC ILLNESS

Code Section 101(g) limits the amount that can be received tax-free under a chronic illness acceleration to the same limit that applies to stand-alone qualified long-term care insurance coverage.

The maximum tax-free benefit payable under a tax-qualified long-term care insurance policy—or under a life policy acceleration for chronic illness—in 2023 is the greater of

- \$420 per day, or
- actual amounts paid for qualified long-term care services.

The per diem tax-free amount does not have to be paid daily—the Code only requires that amounts be paid on a “periodic basis without regard to the expenses incurred.”

Qualified long-term care services are the necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services, and maintenance and personal care services that are:

1. required by a chronically ill individual and
2. provided pursuant to a plan of care prescribed by a licensed health care practitioner.

EFFECT ON PREMIUM DEDUCTIBILITY

We have written in the past about the potential premium deductibility associated with stand-alone qualified long-term care insurance policies.

Since the benefits payable under a chronic illness acceleration are similar to those under a stand-alone long-term care insurance policy, do life policies with acceleration features enjoy any sort of special premium deductibility? Unfortunately, no. Section 264 still says the policy owner may not deduct the premium for a life policy, and nothing in Section 101(g) overrides that fact.

THIRD-PARTY OWNERSHIP

What special issues need to be considered with regard to terminal or chronic illness when the owner of the policy is not also the insured?

While the availability of an acceleration benefit is triggered by the insured's terminal illness or chronic illness, the policyowner is the one who asks for and receives the money. The policyowner—absent a separate agreement—is under no obligation to share the benefit with the insured.

What about the taxation of benefits payable to a third party?

Business Ownership

When a business owns a key person life policy, it is under no obligation to share the death benefit or acceleration benefit with the insured without an explicit agreement to do so.

If a business owns key person life insurance, Section 101(g)(5) makes clear that any terminal or chronic illness acceleration is not treated as a tax-free death benefit.

[These rules] 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.

If an acceleration claimed by the business owner of a life policy is not treated as a tax-free death benefit, such an acceleration would be taxable based on normal life insurance taxation principles. That would mean for a non-MEC policy an amount equal to basis would come out first and be tax-free, while any amount accelerated in excess of basis would be income taxable to the business.

Some business owners have decided to include provisions in their buy-sell agreements that include buyout triggers for terminal or chronic illness. Even without the tax advantages available for personally owned insurance accelerations, such businesses may choose to fund their buy-sell arrangements with acceleration products.

Family or Irrevocable Trust Ownership

Some might choose to have noninsured family members be the owners of policies that include acceleration features. Usually, the reason for such a structure comes down to control over the policy.

EXAMPLE: Mark Jones owns a policy on the life of his father Matthew. Matthew has become chronically ill, and Mark decides to access the acceleration benefit.

Most of the language included in Section 101(g) of the Revenue Code seems to contemplate the insured being the owner of the life contract—with the exception of the specific language of subsection (5) that applies to business-owned policies.

In the example, is the acceleration benefit Mark receives tax-free? The IRS has never addressed this question directly. Congress and the president—when they enacted Code Section 101(g)—chose to single out business-owned policies for exclusion but not third-party-owned personal coverage. That fact, combined with the language of the rest of Section 101(g), makes it seem likely that the benefits paid to Mark would still be tax-free.

It may not be a good idea to have an irrevocable life insurance trust own the life policy when the insured wants to access the chronic illness acceleration. 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 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 at risk.

It is possible to use one or more the trust beneficiaries—including spouse, if desired—as potential conduits for chronic illness payments back to the insured. There are two important drawbacks to this:

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

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. For those situations where the insured wants to have both access to an accelerated benefit and estate tax exclusion, it may be prudent to consider the purchase of two policies—one that will be ILIT-owned to manage estate taxes and the other personally owned to give the insured access to a potential acceleration.

NONCONTRACTUAL ACCELERATIONS

The life settlement insurance market has grown and matured over the past 30 years. Settlement companies will often offer to buy term or permanent life insurance policies where the insured is merely a worse risk than he or she was at the policy's inception.

Code Section 101(g) makes clear that if a settlement transaction of a life policy is made to a licensed viatical settlement company when the insured is chronically or terminally ill, some or all of the proceeds will still be treated as a tax-free death benefit.

If any portion of the death benefit under a life insurance contract on the life of an insured (who is terminally or chronically ill) is sold or assigned to a viatical settlement provider, the amount paid for the sale or assignment of such portion shall be treated as an amount paid under the life insurance contract by reason of the death of such insured.

So for those who own policies for which accelerations for chronic or terminal illness are not available from the insurance carrier, it may still be possible for certain insureds to receive tax-free money from a life settlement company.

Tax Reporting

Payers of accelerated life insurance benefits—including insurance companies, governmental units, and viatical settlement providers—to chronically ill or terminally ill policyowners must file Form 1099-LTC. We have reproduced the most current version of the form below.

9393		<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED	
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross long-term care benefits paid	OMB No. 1545-1519 Form 1099-LTC (Rev. October 2019)
		2 Accelerated death benefits paid	For calendar year 20__
PAYER'S TIN	POLICYHOLDER'S TIN	3 Check one: <input type="checkbox"/> Per diem <input type="checkbox"/> Reimbursed amount	INSURED'S TIN
POLICYHOLDER'S name		INSURED'S name	
Street address (including apt. no.)		Street address (including apt. no.)	
City or town, state or province, country, and ZIP or foreign postal code		City or town, state or province, country, and ZIP or foreign postal code	
Account number (see instructions)	4 Qualified contract (optional) <input type="checkbox"/>	5 Check, if applicable <input type="checkbox"/> Chronically ill <input type="checkbox"/> Date certified <input type="checkbox"/> Terminally ill	

Form **1099-LTC** (Rev. 10-2019) Cat. No. 23021Z www.irs.gov/Form1099LTC Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

Long-Term Care and Accelerated Death Benefits

Copy A
For Internal Revenue Service Center
File with Form 1096.
For Privacy Act and Paperwork Reduction Act Notice, see the current General Instructions for Certain Information Returns.

Here are a few observations:

The Service would know that a life policy death benefit has been accelerated if Field 2 rather than Field 1 is filled in.

For chronic illness accelerations, the insurance company will likely always check the “per diem” box in Field 3. That would be consistent with the IRS’s instructions.

If the information on the form is complete, the IRS would know if the insured and policyowner are different. See the fields in the middle of the form.

As with all 1099 forms, it is possible that the life insurance company or life settlement company could get some details wrong. The IRS expects the taxpayer who receives an acceleration to report the correct tax result.

CONCLUSION

We have written about the tax advantages of permanent life insurance in the past. For non-MEC policies, withdrawals up to basis are tax-free. Loans are not treated as taxable distributions at all so long as the contract stays in force until death. And for nearly all life insurance policies, the death benefit is income tax-free.

The life insurance industry has seen fit to market hybrid life policies that offer death benefit acceleration features to policyowners. Congress and the president have decided that such products should be blessed with positive income tax attributes. Chronic illness-acceleration life products will likely become even more attractive in the future as the pool of companies offering stand-alone long-term care insurance continues to dwindle.

While each company that offers acceleration features for their life insurance policy owners may have slightly different versions, the tax rules are relatively clear. Even for policies where acceleration is not baked-in, the policyowner may still be able to take advantage of life settlement under the right circumstances.

Many of our clients will be unaware of the availability of acceleration options. Others may be uncertain of the practical or tax details. It is up to us to educate them where needed and to guide them through the acceleration process if the time comes.



LAGOS
WEALTH ADVISORS

BUILDING. PROTECTING AND PERPETUATING FAMILY WEALTH

**1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765**

Phone: 866-444-4964, Fax: 714-940-0889

IN THIS ISSUE OF ADVISOR'S BULLETIN

What Every Financial Professional Needs to Know About Life Policy Accelerations

Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

IMPORTANT NOTICE: PLEASE READ

The Advisor's Bulletin is not intended to be a source of advice. This is only an update of current laws regarding Estate and Insurance Planning. Please seek professional consultation for more further information. Securities offered only by duly registered individuals through Madison Avenue Securities, LLC ("MAS"), member FINRA/SIPC. Advisory and insurance services offered through Lagos Financial & Insurance Services, Inc. (DBA Lagos Wealth Advisors), a registered investment advisor in the State of California. CA Insurance License #8B60836. Lagos Wealth Advisors and MAS are not affiliated entities. This information is for Advisor's Use Only—Not for client distribution.