

Business & Estate Advisers, Inc.
With Your Interest In Mind

CASE OF THE QUARTER
CASE # 9

**Recovering Life Insurance Losses on your
Tax Return when the IRS says you can't!**

Facts

Client purchased a Universal Life Insurance policy with high interest assumptions and low premium commitments in the 80's.

Problem

Client had paid total premiums of \$25,000 and has a current cash value of \$2,000. The policy is expected to lapse with no value within the next three to four years.

Recommendations

- Life Insurance Tax law states that if the client surrenders the policy for current cash value then they are not allowed to take a tax loss for the \$23,000 loss!
- Section 1035 Tax law states that you may move an existing annuity to a new annuity or you may move an existing life insurance policy to a new life insurance policy with a transfer of original cost basis. Section 1035 also states that you cannot move an existing annuity to a new life insurance policy but you can move an existing life insurance policy to a new annuity and retain the cost basis.
- By taking advantage of the Section 1035 law and using the little remembered option of "moving existing life insurance to a new annuity" the following benefits can be realized.
 - The \$2,000 can be moved to an annuity that now has a basis of \$25,000. The client could wait many years to have the annuity grow to \$25,000 (tax free) or could add capital. For example adding \$200,000 to the annuity would mean it now has a current value of \$202,000 with a cost basis of \$225,000. Thus \$23,000 could be recovered free of tax as the annuity value increased.
 - Or the client can move \$2,000 to an annuity and have a "non-contemplated event" take place in a year or two (a contemplated event would be subject to the step transaction rules and the benefits would be lost). If two years later the annuity was surrendered an ordinary loss of \$23,000 could be taken. An ordinary loss can be used dollar for dollar against all income while a capital loss is limited to a \$3,000 annual use against ordinary income. This concept is not tax law but it is believed to be acceptable since the IRS requires that gains on Annuities be taxed at ordinary rates. The general feeling is that they must have it both ways if they want it one way.

Bottom Line

In our clients situation a \$23,000 tax benefit was realized by using this technique. In the absence of this technique the tax benefit would have been lost at policy lapse or surrender as would have the tax benefit.

This is a hypothetical example for illustrative purposes only. Any tax advice contained herein is of a general nature and is not intended for public dissemination. Further, you should seek specific tax advice from your tax professional before pursuing any idea contemplated herein. This advice is being provided solely as an incidental service to our business as financial planner. Securities offered through ValMark Securities, Inc. Member FINRA, SIPC. Financial Planning and Investment Advisory Services offered through B & E Investment Advisers, Inc. Business & Estate Advisers, Inc. and B & E Investment Advisers, Inc. are separate entities from ValMark Securities.