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THE FEDERAL INCOME TAXATION OF
LIFE INSURANCE, ANNUITIES AND
INDIVIDUAL RETIREMENT ACCOUNTS
AFTER THE TAX REFORM ACT OF 1986

THEODORE PAUL Manno*

An author examining the income taxation of life insurance products, including annuities and individual retirement accounts (IRAs), realizes that, to even the most learned general practitioner, the language of the Internal Revenue Code sometimes appears to have been co-authored by James Joyce and Casey Stengel. Further difficulties are encountered with such complex insurance concepts as "split dollar,"1 "net amount at risk,"2 and "the fifth dividend option,"3 often rendering expert tax counsel wary of advising clients on the consequences of proposed insurance strategies.

This area has been further complicated by the trilogy of tax legislation which ended on October 22, 1986, the signing of the Tax Reform Act of 1986.4 A new order of taxation evolved from the Tax

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1 See infra note 38 and accompanying text (definition of split dollar policy).
2 See S. Huebner & K. Black, Life Insurance 7 (10th ed. 1982). The "net amount at risk" is basically the amount the insurer would pay on a given date were death to occur, minus the amount, if any, that the policyholder would have received on that date as the cash surrender value had the policyholder surrendered the policy while living. Id.
3 See generally id. at 398. Dividends on policies represent a return to the policyholder of premium amounts which were not actually needed to pay for the coverage. This is caused by the fact that actuarial computations are done on conservative estimates of mortality and investment return. Rather than actually receiving the dividend in cash, policyholders can elect a number of automatic uses for it. A "fifth" option to become popular was the use of the dividend to purchase an amount of term insurance equal to the cash value, and then, if any amount remained, to reduce premiums on the underlying coverage. See, e.g., J. Pedoe, Life Insurance, Annuities, & Pensions 174 (2d ed. 1970). By purchasing one-year term insurance each year exactly equal to the cash value, the net amount for which the insurer is "at-risk" remains the same every year.
Equity and Fiscal Responsibility Act of 1982 (TEFRA)⁶ and the Deficit Reduction Act of 1984 (DEFRA),⁸ the final contours of which the Tax Reform Act has attempted to mold. The aim of this article will be to serve as a guide to this evolution for general practitioners without sacrificing the detail and analysis necessary to make this treatment a valuable source for attorneys who specialize in this area.

**Life Insurance**

In discussing the tax implications in the area of life insurance, of main concern is the treatment accorded transactions involving the cash value account of a policy. This is not an issue when dealing with term life insurance inasmuch as the policyholder has no right to receive any amount under the policy if he decides to terminate the coverage during the particular period or term.⁷ “Ordinary life”⁸ and the more recently developed “universal life”⁹ contracts, however, have a cash value.¹⁰ Surrender of these policies by the policyholder during his lifetime results in the payment by the insurer to the policyholder of this cash value. If no surrender is made, the cash value continues to grow within the policy resulting in “inside build-up.” As long as the policy conforms to the definition of life insurance in section 7702 of the Internal Revenue

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⁷ Ordinarily life insurance has been defined as “[w]hole life insurance usually issued in amounts of $1000 or more, with premiums payable annually, semi-annually, quarterly, or monthly.” Whole life insurance is, in turn, defined as “[c]overage until death for payment of a specified payment of a specified premium.” 2 Ernst & Whinney, Federal Income Taxation of Life Insurance Companies G-20 and G-28 (1984).

The death benefit under universal life consists of a cash fund plus a layer of term insurance, both of which are explicitly identified to the policyholder. The cost of the term portion of the death benefit is borne by periodic charges against the cash value. The policyholder is generally free to make premium payments in any amount at any time.


¹⁰ See S. Heubner and K. Black, supra note 2, at 71.
This "inside build-up" is not included in gross income for federal tax purposes.

The cash value account can also be utilized by the policyholder without surrendering the contract in its entirety. One method is by borrowing from the insurer a portion of that account. There is no personal liability to repay in such an insurance policy loan; the debt cannot be collected by the insurer from any asset of the debtor other than the policy itself. These policy loans generically have the status of "nonrecourse" debts, which, as such, are a legitimate form of indebtedness. Thus, there arises the issue of whether the interest paid on policy loans is deductible under federal law.

**Policy Loan Interest Deductions**

In the Internal Revenue Code of 1954, section 264 was the pivotal statutory provision relating to the deductibility of interest paid on insurance policy loans. Before the passage of the Tax Reform Act of 1986, the principles enunciated in that section of the code were applied without regard to the taxpayer's status as an individual or an employer, or to the dollar amount of the loan. Section 264 did make a distinction, even before 1986, with respect to the mode of premium payment. Section 264(a)(2) states that no interest is deductible with respect to a single premium policy, defined as one in which "substantially all" the premiums are due within the first four years of the policy. As to policies which are not single premium policies, section 264(a)(3) states that interest is

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11 See infra notes 78-81 and accompanying text (discussion of section 7702 definition).
12 See Mosemy Garrison, Siskin Memorial Found. v. United States, 790 F.2d 480, 482 (6th Cir. 1986) (holding that withdrawals against cash value of life insurance create indebtedness). See also Minnis v. Commissioner, 71 T.C. 1049, 1054 (1979) (policy loans generally regarded as form of indebtedness); Salley v. Commissioner, 55 T.C. 896, 903 (1971) (obligation of borrower to pay interest on life insurance loan sufficient to support tax deduction), aff'd, 464 F.2d 479 (5th Cir. 1972). The confusion that exists over the distinction between policy loans and policy withdrawals is exemplified by the fact that the Siskin case refers to the amounts taken from the contract as being "withdrawals" when even a cursory reading of the decision clearly indicates they are loans.
13 See Commissioner v. Tufts, 461 U.S. 300, 317 (1983) (nonrecourse debt is legitimate debt because if property encumbered by such is sold, amount of debt is required to be included in amount realized on the sale). See generally Miller, The Supreme Court Does It Again in Tufts: Right Answer, Wrong Reason, 11 J. REAL ESTAT. TAX'N 3 (1983) (strength and weaknesses of Tufts decision).
14 I.R.C. § 264(b) (1982). The Tax Court has held in the single premium context, that 73% is not "substantially all." Dudderar v. Commissioner, 44 T.C. 632, 633 (1965).
not deductible if borrowing is contemplated, a subjective standard depending upon the policyholder's state of mind or intent. Guidance as to that intent is provided by section 264(c)(1), which states that for purposes of the 264(a)(3) "contemplation rule," the taxpayer is conclusively presumed not to have the forbidden intent if one of four circumstances is met. The one test most often cited and relied on by counsel as a safe harbor is the "four-out-of-seven" rule of section 264(c)(1). This objective mathematical test states that if the taxpayer does not utilize borrowing to pay any four of the first seven annual premiums due on the policy, the taxpayer is not deemed to have contemplated borrowing for purposes of the section 264(a)(3) prohibition. Thus, prior to the Tax Reform Act of 1986, as long as the "four-out-of-seven" rule was satisfied, the full amount of the policy loan interest was generally deductible, both for individuals and corporations.

The first major change in this area under the Internal Revenue Code of 1986 is the distinction now drawn between individual and business taxpayers. Individuals are now effectively barred from deducting policy loan interest, even if they comply with the "four-out-of-seven rule," unless one of the four exceptions to the "personal interest rules" is satisfied by the use of the proceeds. However, a business taxpayer's or employer's ability to deduct this interest is now subject to a dollar limitation.

For noncorporate taxpayers, the Tax Reform Act of 1986 denies all "investment interest" deductions in excess of the taxpayer's investment income, and eliminates all "personal interest"

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16 See I.R.C. § 264(c) (1982). One of these circumstances is when the interest is de minimis, that is, less than $100. Id. at § 264(c)(2). Others, including borrowing because of an "unforeseen substantial loss of income or unforeseen substantial increase in . . . financial obligations," id. at § 264 (c)(3), or borrowing "in connection with [a] trade or business," id. at § 264 (c)(4), seem to be very narrowly interpreted by the relevant Treasury regulations. See Treas. Reg. § 1.264-4 (1964). While these two exceptions may be of use in a defense posture, their inherent dependence upon the facts and circumstances of each case and the Treasury's apparent intent to circumscribe them, argue strongly against relying on them in a planning situation. It must also be noted that the trade or business exception is subject to the $50,000 limit recently imposed on employer's ability to deduct interest on policy loans. See infra notes 49-52 and accompanying text.


17 See infra notes 20-23 and accompanying text.

18 See infra notes 49-52 and accompanying text.
deductions. "Personal interest" includes interest on policy loans other than: (1) policy loans incurred or continued to purchase or carry property held for investment; (2) interest which is taken into account in calculating income or loss from a "passive" activity, that is, a tax shelter; (3) loans taken to pay interest on estate taxes deferred under section 6166; and (4) interest incurred in carrying on a trade or business.

Moreover, the effective date of the provision disallowing deductibility of interest is exceedingly strict. Interest paid in 1987 or later is subject to this rule of nondeductibility, regardless of the year in which the policy was purchased or the year in which the loan was made. There is, however, a "phase-in" provision applicable to personal interest.

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21 Id. at § 163 (h)(2)(E) (as amended). Interest with respect to passive activity is subject to the new provisions concerning limitations on loss deductions from such activities. See id. at § 469.

22 Id. at § 163(h)(2)(E) (as amended). The new code at section 163(h)(2)(D) also excepts from the definition of personal interest "any qualified residence interest" within the meaning of section 163(h)(3). Since "qualified residence interest" is defined in subparagraphs 3(A) and 5(A) of IRC § 163(h) as interest which is paid or accrued during the taxable year on indebtedness which is secured by the principle residence of the taxpayer or one other residence, and since insurance policy loans are only secured by the policy itself, the section 163(h)(2)(D) exception is irrelevant to policy loans. A separate provision affects interest paid by a taxpayer on federal estate taxes under section 6166 of the Code. Any portion of the federal estate tax which is attributable to the ownership of certain closely held business interests can be paid over a ten year period, after a four year deferral, if the closely held interests constitute at least 35% of the adjusted gross estate. Id. at § 6166. An important element of the statutory scheme is the cross-reference in section 6166(f) to section 6601. The latter section provides that during the "interest-only" period, the interest payable on all amounts up to $153,000 of the deferred liability shall be paid at a 4% rate. See id. at § 6601(j). It is significant to note that while the Internal Revenue Code of 1986 provides that the prohibition against the deduction of personal interest generally applies to interest paid on federal tax underpayments, it does not apply with respect to payments under section 6166. See id. at § 163(h)(2)(E).

23 Id. at § 163(h)(2)(A). However, this last exception is also affected by a separate provision of the Tax Reform Act which limits the deduction which an employer can take with respect to loans on policies on the lives of employees and persons financially interested in the business. See infra notes 49-52 and accompanying text.

24 See id. at § 163(h).

25 See id. at § 163(h)(6) and (d)(6)(B). For the taxable year which begins in 1987, the taxpayer may deduct 65% of the interest which is nondeductible solely because of these provisions; in 1988, 40% of such amounts are eligible for deductibility; in 1989, 20% is de-
It should also be noted that the new tax act contains no specific provision allowing the nondeductible policy loan interest to be added to the basis for purposes of determining the potential gain the policyholder must include in gross income or surrender of the policy, or on receipt of withdrawals or other sums from the policy. Consistent with this principle, amounts received during the insured's lifetime from an insurance or annuity contract cannot be included in gross income for tax purposes unless, at the very minimum, the cash value (including amounts previously withdrawn) exceeds the aggregate premiums or other consideration paid for the policy. Clearly, counsel can, and should, argue that nondeductible interest payments are encompassed within the statutory definition of "other consideration paid" for the policy under section 72(e)(6) and should therefore be included in the basis. However, the lack of a specific provision to that effect in the final text of the 1986 Act, when contrasted to the specific allowance of such an addition to the basis in an earlier tax reform proposal, would make the ultimate success of this argument questionable.

The imposition of these severe restrictions on policy loan interest deductions for individuals, together with the general decline in individual tax rates, will make minimum deposit plans less desirable. "Minimum deposit" is a broad term which is used here to connote any method of premium payment which involves extensive borrowing against the policy cash value to pay future premiums, and the utilization of the tax savings generated by those interest payment deductions so that the life insurance coverage will pre-

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2 Under the Internal Revenue Code, gain equals the amount realized less the taxpayer's adjusted basis in the property. I.R.C. § 1001 (1982). As a general rule, "basis" equals the cost of the property. Id. at § 1012.

27 Id. at § 72. In addition, as will be discussed, until the advent of TEFRA in 1982, amounts withdrawn from annuities were also not included in gross income until they exceeded basis; amounts received from life insurance contracts are included in gross income only when they exceed basis, unless certain mathematical relationships between the cash value and the death benefit are violated during the first fifteen policy years. See infra notes 89-94 and accompanying text.

28 But see Chapin v. McGowan, 271 F.2d 856, 858 (2d Cir. 1959) (interest on funds borrowed to pay insurance premiums are not includible as consideration paid for policy).

29 See STAFF OF JT. COMM. ON TAX'N, 99th CONG., 2d SESS., TAX REFORM OPTIONS, Title X(A)(1)(b) at 42 (1986). This proposal stated that "interest on policyholder loans would be treated as a nondeductible premium payment." Under section 72(e), all premium payments are included in basis. See supra note 27 and accompanying text.
The potential attractiveness of many minimum deposit plans rested upon an interrelated chain of assumptions. One of the assumptions was the continuation of a 50% or close to 50% tax bracket so that a deductible interest expense produced a tax benefit roughly equal to half the expense, and another was the continued deductibility of policy loan interest for individuals. Neither one of these two assumptions remains viable under the 1986 Act.

The future nondeductibility of policy loan interest also adversely affects taxpayers who use the cash method of accounting and were thus unable to deduct policy loan interest even under pre-1986 law because they did not actually pay it out-of-pocket. As in certain minimum deposit plans, these cash-basis taxpayers would add the amount of the interest to the amount of the loan which was already encumbering the policy value. The case most often cited for this premise is Battelstein v. Commissioner.

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31 See Beck, Perspectives on Minimum Deposit, supra note 30, at 34-37.

32 See I.R.C. §§ 1 and 11 (West Supp. 1987). Under the new tax law, individual income tax rates will range from 11% to 38.5% in 1987. In 1988, the maximum tax rate will nominally be 28%, but because taxpayers will suffer a “phase-out” of personal exemptions and the benefits of the 15% rate at a particular point, depending on marital and filing status, an effective rate of up to 33% will apply to certain income.

33 Compare Treas. Reg. § 1.461-1(a)(1) (1967) with Treas. Reg. § 1.461-1(a)(2) (1967). Taxpayers who use the cash method of accounting can only deduct an otherwise allowable expense in the taxable year in which the expense is actually paid; in contrast, accrual basis taxpayers can deduct when all events necessary to fix liability have occurred, and the amount thereof can be reasonably ascertained.

34 See, e.g., Keith v. Commissioner, 139 F.2d 596 (2d Cir. 1944) (where taxpayer owed interest on life insurance policy loan obtained additional loans and applied to payment of such interest, amount of interest not deductible); Prime v. Commissioner, 39 B.T.A. 487 (1939) (interest of life insurance policy loan added to principal when due and remained unpaid by holder held not deductible); Thomason v. Commissioner, 33 B.T.A. 576 (1935) (giving of new note does not entitle one to deduction for interest paid since no actual payment); Rev. Rul. 73-482, 1973-2 C.B. 44 (cash basis taxpayer only entitled to deduction for interest actually paid).

35 631 F.2d 1182 (5th Cir. 1980). See also Wilkerson v. Commissioner, 655 F.2d 980 (9th Cir. 1981). Although these cases did not specifically mention insurance policy loans, the conclusion that they were relevant to minimum deposits was not difficult to reach. This relevance became even more pronounced when the Internal Revenue Service in 1983 “reminded” cash basis taxpayers that interest deductions would not be allowed when the taxpayer paid the interest expense with “funds obtained from a creditor through a second loan, an advance, or any financial arrangement similar to a loan.” I.R.S. News Release IR-83-93 (July 6, 1983). Again, the Service’s language would seem to apply the prohibition to plans of
Before the 1986 Tax Act, otherwise deductible amounts which were disallowed because of the "Battelstein doctrine" eventually became deductible in the taxable year in which the interest was subtracted from the cash amount owed to the policyholder upon the surrender or exchange of the policy, to the beneficiary at the insured's death, or when the policy lapsed by reason of nonpayment of premiums. However, if these events were now to occur after 1986, the deemed "payment" of the interest caused by these events would be subject to the personal interest nondeductibility rules discussed herein. Policyholders in this situation who have not paid their accumulated interest by an unrelated cash payment before January 1, 1987 will wish to do so before the end of the phase-out period in 1991, to preserve the deduction of at least part of the actual payment, and to avoid having the later "deemed" payment disallowed.

Another area in which these changes will have some impact is the taxation of "split-dollar" insurance policies. Split-dollar is essentially a contractual arrangement in which an employer can pay all or part of the premium for the policy pursuant to an agreement with the insured-employee under which "the employer is entitled to receive, out of the proceeds of the policy, an amount equal to the cash surrender value, or at least a sufficient part thereof to equal the funds it has provided for premium payments." Minimum deposit in which the policy holder borrows from the cash value to pay interest on loans previously taken from the cash value.

See, e.g., Estate of Hooks v. Commissioner, 22 T.C. 502 (1954) (interest on policy loans which insurer bound to deduct from settlement of policies on death of insured held paid and deductible by surviving spouse); Cheeseman v. Commissioner, 28 T.C.M. (CCH) 1334 (1969) (cash basis treatment); Rev. Rul. 73-482, 1973-2 C.B. 44 (distinguishes cash basis taxpayer's nonability to deduct under certain circumstances).

See supra notes 19-25 and accompanying text.

Rev. Rul. 64-328, 1964-2 C.B. 11. See generally Fizer, Split Dollar Life Insurance, TRUSTS & ESTATES 11 (July 1982) (income, estate and gift tax consequences of split dollar plans); Singer, Second Generation Split Dollar Plans, C.L.U. J. 50 (July 1983) (variations on traditional split dollar plans). With respect to life insurance which is not provided to selected employees but rather to employees as a group, the new law subjects group-term life insurance to the new "Nondiscrimination Rules for Certain Statutory Benefits," and makes certain technical corrections to the DEFRA provisions affecting such coverage. See Act, supra note 4, at §§ 1151, 1827 and 1851.

The employer's contractual right under the split dollar agreement to recoup its premiums paid can be reflected in a collateral assignment of the policy with the insured-employee as policyholder. Alternatively, the employer can be the policyholder, with the employee's rights reflected in an endorsement on the policy. See Rev. Rul. 64-328, 1964-2 C.B. 11. The employee is free to name anyone he chooses as beneficiary of the remaining portion of the death benefit. See id.
The Internal Revenue Service ("IRS") has specifically ruled that an employer's right to recover the amount to which it is entitled does not constitute an interest-free loan. Thus, the changes enacted by DEFRA with respect to such loans, and the personal interest limitations in the 1986 Tax Reform Act, do not impact on the taxation of the economic benefit which is conferred upon the employee in current and future split-dollar plans, as long as the plans are in effect.

In the context of interest-free loans made after June 6, 1984, DEFRA essentially stated that if an obligation to repay money is entered into in an employer-employee setting, and is payable upon demand, the interest which was not charged ("foregone interest") is treated for tax purposes each year as if it had been paid to the lender by the borrower, and then returned to the borrower by the lender. Therefore, in a "corporation to shareholder" situation, the interest amount which is deemed to have been returned to the employee-borrower each year is characterized as a dividend, taxable to the borrower and not deductible by the lender; in an "employer to employee situation" it is compensation, taxable to the borrower and presumably deductible by the lender. The other fictional transfer, that is, the original "payment" of interest to the lender, is interest income to the lender. It is also deductible to the borrower unless disallowed by some other provision such as section 265 which prohibits interest deductions on borrowing to invest in tax-

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40 See I.R.C. § 7872 (a)(1)(A), (B) (West Supp. 1987) (added by DEFRA, supra note 6, at § 172). The provision applies of course not only to loans on which no interest is paid but also to all loans on which less than a market rate of interest is charged. A "demand loan" is defined in I.R.C. § 7872(f)(5) (West Supp. 1987).

41 I.R.C. § 7872(c)(1)(B), (C) (West Supp. 1987). The calculation of the dollar amount of the interest which is deemed paid and received though this legal fiction is done on an annual basis. See id. at § 7872(b)(2). When a loan is made to an employee and is payable at the end of a specified term, the lender is deemed to be transferring to the employee an amount equal to the sum transferred less the discounted value of the borrower's promise to repay the sum at the end of the term. See id. at § 7872(b)(1). This inclusion of a substantial sum in the gross income of the employee would normally make the use of a term loan inadvisable even without the prohibitions against interest deductions for the deemed payments of foregone interest thereafter. For a discussion of below-market rate loans in the non-business context see generally Wilbanks, Interest-Free Loans are No Longer Tax-Free: Tax Consequences of Gift Loans, 47 MONT. L. REV. 39 (1986).
exempt securities; the four-out-of-seven rule discussed above or, the personal interest rules.

If interest-free loan treatment were proper for split dollar plans, the "imputed interest" each year on the loan would be interest income to the employer, and compensation income to the employee. The employer would presumably receive an offsetting deduction, because its "payment" of the compensation would be an ordinary and necessary business expense. If the employee were a shareholder, the IRS could disallow the deduction by claiming that the "payment" was a dividend. In any case, the employee would not enjoy an offsetting deduction for interest paid. This pattern of taxation, however, does not apply to a split dollar plan because, as stated above, the IRS has rejected "loan treatment" for these plans. The proposed regulations concerning interest-free loans confirm that they are not intended to cover such an arrangement.

The 1984 and 1986 tax legislation may nonetheless have an unfavorable impact when parties terminate the split-dollar agreement if they do so without reimbursing the employer at that point in time for the amount due under the agreement. One customary method of terminating a split-dollar arrangement has been a cancellation of the contractual agreement to pay premiums, accompa-
nied by the execution of a collateral assignment securing the employer's right to recover the premium amounts previously paid. The assignment, and any promissory note evidencing this debt, were typically noninterest-bearing. This arrangement does appear to constitute an interest-free loan, and the parties are estopped from invoking the protection afforded to split-dollar agreements by the IRS because the parties have terminated the agreement. As a result, the employee would have gross income each year for the imputed interest income, but would not be able to offset a deduction for the interest "paid" unless an exception to the personal interest rule was found.

Regarding business taxpayers, the 1986 Act, for the first time, places a dollar limit on the deductibility of loans encumbering a policy on the life of any officer or employee of the employer, or on the life of any person financially interested in the taxpayer's trade or business. The taxpayer will now be allowed a deduction of the interest on loans taken against a policy on an individual's life only to the extent such loans do not exceed $50,000. The fact that policy loan proceeds are used in a trade or business "does not affect the deductibility of interest paid on the loan."

The new Act applies this $50,000 ceiling to policies purchased after June 20, 1986. In contrast to the personal interest limitation for individuals, which references the date the interest is paid, policies purchased before June 21, 1986 would not be subject to this

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49 Act, supra note 4, at § 1003 (adding new I.R.C. § 264(a)(4)). Section 264(a)(4) provides:

Any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual who (A) is an officer or employee of, or (B) is any person financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such indebtedness . . . exceeds $50,000.

Id. The new Act incorporates the "Dole Amendment," which was affixed to the bill originally passed by the Senate. See 132 CONG. REC. H. 68051 (daily ed. June 20, 1986) (statement of Senator Dole).
50 If corporations are members of an affiliated group, only a single $50,000 limit is available to the group as a whole. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. 341.
51 See id. The interaction of the dollar limit with the "trade or business" exception of section 264(c)(4) of the code and section 163(h) is specifically addressed by the Conference Committee Report: "[I]f a sole proprietor borrows under a life insurance policy on the sole proprietor's life, the interest paid on the loan (to the extent the loan exceeds $50,000) is not deductible even though the proceeds of the loan are used in the sole proprietor's trade or business." Id.
52 Act, supra note 4, at § 1003(c).
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A dollar limitation regardless of the taxable year in which the debt was incurred or the year in which the interest was paid. A colloquy on the floor of the Senate clearly reflects the further intent of some legislators to exempt from the meaning of the word “purchase” the exercise of “business exchange riders” whereby one insured is substituted for another under a policy owned by a business. To illustrate, if a policy were purchased by a corporation in 1985 on the life of a general manager, and that manager was to terminate employment in 1987, the substitution of a newly-hired general manager as the new insured pursuant to the business exchange rider would not subject loans on that policy to the $50,000 limitation. Concern has been expressed over the effect of this colloquy since “this issue was never discussed, and therefore never agreed to by the conferees.” Where the change of the insured occurs under a policy which retains the same policy number and issue date, it would appear that this concern is unfounded because there is no new policy and thus, no purchase after the effective date.

It was further stated by the floor managers that a change in ownership after the effective date would not trigger the $50,000 limitation. Therefore, it appears that a policy purchased by an individual on or before June 20, 1986, and transferred to his or her employer even after that date could avoid both the “personal interest” prong and the “$50,000 corporate limit prong” of the 1986 Act. This would seem to be the case, even without relying on the Senate colloquy, when the insured individual owns at least 80% of the stock of the corporation employing the insured. Even if a broad reading were given to the word “purchase,” a transfer to a corpora-

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54 132 Cong. Rec. E3389-91 (daily ed. Oct. 2, 1986) (statement of Chairman Rostenkowski on Senate Floor Colloquy regarding H.R. 3838, The Tax Reform Act of 1986). Apparently, exchanges of policies after June 20, 1986 for a policy issued by the same insurer have been exempted from the term “purchase.” This is a rather strange distinction since it is clear that policy exchanges are eligible for tax-free treatment under section 1035 irrespective of whether they are intramural or not. See Rev. Rul. 72-358, 1972-2 C.B. 473. See also Rev. Rul. 68-235, 1968-1 C.B. 360 (holding no gain or loss recognized on exchange of life insurance contract provided all § 1035(a) requirements met). In addition, the TEFRA grandfather rule for annuities is not forfeited by a tax-free exchange regardless of whether the new policy is from the same or a different insurer. See infra note 108. Equally interesting is the fact that the colloquies do not require that section 1035 be satisfied as a condition of preserving the grandfathering. The author understands that it is therefore the opinion of some practitioners that an exchange will suffice even if it does not qualify under section 1035 for tax-free treatment.

tion of which the transferor controls 80% or more is a tax-free transaction under section 351, and gives the corporation a substituted basis under section 362, not a cost basis under section 1012. Since there is no cost basis, it would be very difficult for the IRS to argue on technical grounds that the corporation "purchased" the policy. Thus, even if the statute is interpreted to apply to any purchase and not merely the original purchase from the insurer, the immunity is preserved.

To understand the context in which the amendment was submitted, a distinction must be made between the "insured" on a life insurance policy, and the "policyholder." The insured is the person whose life is the subject of the coverage. His death is the triggering event to the payment of the death benefit. The insured may also be the owner of the policy but need not be. The owner, who is called the policyholder, controls the policy. The owner: (1) names the person or entity who will receive the death benefit at the insured's death; (2) decides the manner in which dividends paid under the policy during the insured's lifetime should be applied; (3) decides whether to borrow against the cash value; and (4) decides if and when to surrender the coverage.

One common example in which a policyholder and the insured are separate entities exists when a corporation purchases insurance on the life of a key employee because it anticipates disruption and lost profits for a reasonable time after the employee's death. Other common reasons for corporate-owned insurance are a corporation's desire to use the death benefit, the cash value, or the loan proceeds to redeem a shareholder's stock, or to pay an employee or a shareholder amounts that the corporation has contracted to pay under a binding deferred compensation agreement. Similar reasons can be found in the context of a partnership. The possibility of

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56 See Treas. Reg. § 1.351-1 (as amended in 1967) (no gain or loss recognized on transfer of property to corporation solely in exchange for stock or securities of such corporation if immediately after exchange, such person owns at least 80% of voting power and shares outstanding).
58 See 2 J. Appleman, INSURANCE LAW AND PRACTICE § 771 (1966); R. Keeton, Basic Text on INSURANCE LAW § 411(a) (1971).
59 See generally 19B J. Appleman, supra note 58, §§ 11136-39 (1982). The terms "key employee" and "key person" (formerly "key man") coverage should properly be applied only to business insurance motivated by the fear of lost profits and increased costs resulting from the death of an officer or employee. Id. Unfortunately, the terms are used loosely in common parlance to connote any corporate-owned policy, regardless of the intended use of the proceeds.
borrowing against the cash values of such firm or corporate-owned policies on a tax-favored basis has now been impaired by the "$50,000 limit" of the 1986 Act. Furthermore, since many businesses are corporations, the combined effect of this limit and the reduction of the maximum corporate tax rate to 34% will be to greatly reduce the attractiveness of the corporate minimum deposit arrangement in a manner similar to the situation for individuals.

Application of different rules for individuals and employers raise the additional issue of the proper treatment to be accorded to indebtedness occurring with respect to the cash value of a policy which is subject to a split dollar agreement. As mentioned previously, such an arrangement can be effected in two ways: the employer may be the owner, or the individual may be the owner. While there is no statutory authority for the proposition, it is submitted that the deductibility of a loan against the cash value should be evaluated not on the basis of the identity of the technical owner of the policy, but rather on whose portion of the death benefit is subject to the loan. Thus, if the employer has the right to recoup the entire cash value, any loan would be an encumbrance against the employer's share, and interest paid on that loan should therefore come within the "$50,000 rule". Conversely, assume the employer is to recoup only the premiums it paid, the cash value

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60 The dollar limit of section 264(a)(4) can be applied as follows: Assume Aragon Corporation has five employees. The corporation owns three ordinary policies on Mr. Boleyn, two policies on Ms. Seymour, one policy on Mr. Cleves, and no policies on Ms. Howard and Mr. Parr. Assume further that there is a $50,000 loan on the first policy on Mr. Boleyn's life, and $15,000 has been borrowed on each of the two other policies: there is a $40,000 loan on one policy on Ms. Seymour's life, and $20,000 on the other; there is no loan on the policy on Mr. Cleves' life. Assume also that the interest rate is 8%, that is, that there is $4,000 payable in interest on a $50,000 loan. The corporation would pay $8,400 in interest on the policies on Mr. Boleyn's life, but only $4,000 is attributable to $50,000 of loans so the deduction for the other $2,400 is disallowed. Likewise as to the coverage on Ms. Seymour, the interest on $60,000 would be $4,800, so $800 would be disallowed. There are no loans on Mr. Cleves's coverage, so there is no deduction. It is significant that even though the total amount of loans in this hypothetical ($80,000 plus $60,000, $140,000) equals less than $50,000 times the number of covered employees ($150,000), there is no authority in the Act allowing a "carry-over" or credit from one employee's coverage to another.

61 Act, supra note 4, at § 601 (amending I.R.C. § 11). The amended version of section 11 is effective for taxable years beginning on or after July 1, 1987. Certain segments will be taxed at 39% in a manner similar to the phase-out applicable to individual taxpayers. Cf. Act, supra note 4, at § 101(a).

62 See supra notes 31-32 and accompanying text.

63 But cf. Dean v. Commissioner, 35 T.C. 1083 (1961) (assignee and not assignor of insurance policy can deduct interest on policy loans assuming assignee pays the interest).
exceeds that amount at a particular point in time, and the contracting parties arrange for the loan to be charged only against the employee’s portion of the cash value. It is logical to assume that the “personal interest rules” would apply, since the loan is being made in substance by the individual, regardless of which method of policy ownership is used. There still remains the issue of whether or not interest deductions are allowed at all on universal life contracts, regardless of the taxpayer’s status. There can be no doubt that the rule that interest deductions for single premium policy loans are banned remains intact. Nevertheless, neither the statute, nor the legislative history, states how a universal life policy is to be classified except “that universal life is not always treated as a single premium policy.”

While the discussion heretofore discussed interest paid by the

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The Ways and Means Committee Report to the original House Tax Reform Bill purported to restate the rule that interest deductions are never allowed for single premium policies. The Report specifically states that the intent of its “clarification” is to render nugatory the claims of “some practitioners” who had apparently asserted that the exceptions in section 264(c) could be utilized to override the rule against interest deductions for single premium policies. House Ways and Means Comm. Report to H.R. 3838, H.R. Rep. No. 426, 99th Cong., 1st Sess. 660-61, reprinted in Standard Fed’l Tax Reports No. 53 (CCH Special 7 1985)[hereinafter H. Rpt.]. Section 264(c) specifically states that “for purposes of subsection (a)(3) above,” the four exceptions permitting deductibility shall apply. Id. Subsection (a)(3) applies only to “other than single premium policies,” while (a)(2) specifically governs single premium contracts. Hence, since any assertion to the contrary would be statutorily flawed, there should be no disagreement with the congressional conclusion that the exceptions do not apply to single premium policies. Accordingly, deductions on policies on which substantially all of the premiums are paid within the first four years of the contract are clearly disallowed.

More importantly for our purposes, the House Report also stated that one of the reasons for its “clarification” was that “it has come to the Committee’s attention that some practitioners may characterize a universal life insurance policy as a contract that provides for annual premiums due for purposes of the four out of seven rule.” H. Rpt. at 660-61. The clarification, however, never stated whether or not interest deductions for universal life are permitted under the “four-out-of-seven rule.” Nor did the report state whether the policy is deemed to be subject to the nondeductibility rule for single premium contracts. Because the issue of whether universal life is a single premium policy is such a pivotal issue, it was assumed that the final Act or Committee Report would address it meaningfully. Unfortunately, the Joint Committee on Taxation’s summary of the Conference Committee agreement stated only that the Senate accepted the House Committee Report language on this. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-340, reprinted in 1986 U.S. Code Cong. & Admin. News 340. Finally, the Conference Committee Report to the final text of the Act stated: “Generally, section 264(a)(2) also applies to contracts other than those where the nonpayment of premiums would cause the policy to lapse, but no inference is intended that universal life policies are always treated as single premium contracts.” Id.
taxpayer to the insurer, there is also a change in the 1986 Act concerning interest received from the insurer. Under section 101(a) of the code, life insurance death benefit proceeds are generally excluded from gross income for federal tax purposes. This favorable income tax-free treatment is retained under the 1986 Act. Under previous law, however, when the proceeds were paid in installments, a surviving spouse (but no other beneficiary) was also able to exclude $1,000 of the interest element of the payment each year.65 The new Act abolishes this, and makes the interest element totally taxable to all taxpayers.66

**Withdrawals From The Cash Value**

The cash value is not only a source of loans, it can also be a source of non-debt withdrawals. Prior to August 13, 1982, non-recurring withdrawals from both annuity contracts and life insurance policies were included in the policyholder's gross income only when the aggregate amounts received under the contract exceeded the premiums paid for that contract.67 Basically, the taxpayer was allowed to recover basis fully before being taxed. As will be discussed below, TEFRA changed this rule as to annuities, and also treated annuity loans as if they were withdrawals.68 The 1982 Act, however, retained the cost recovery principle with respect to life insurance, and continued to treat insurance policy loans as loans and not as withdrawals.69 A fair reading of TEFRA of 1984 after its

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65 See I.R.C. § 101(d)(1) (1982) (repealed by Act, supra note 4, at § 1001(a)).
66 Act, supra note 4, at § 1001(a) (amending I.R.C. § 101(d) (1982)). Section 1001(a) applies to amounts received with respect to deaths occurring after Dec. 31, 1986, in taxable years ending after that date. See Senate Finance Comm. Rpt. TRA 1986, supra note 54, at 488. The new statute also directs insurers to use sex-neutral life expectancy tables prescribed by the Treasury in calculating the difference between the portion of each installment attributable to the nontaxable benefit, and the portion which is taxable as the interest element. Act, supra note 4, at § 1001(b) (amending I.R.C. § 101(d)(2)(B)(ii) (1982)).
67 See I.R.C. § 72(e) (1972) (amendment by TEFRA, supra note 5, at § 265; infra note 104 and accompanying text (former cost recovery for annuity). “Aggregate amounts received” included actual withdrawals and unrepaid policy loans which are extinguished on surrender or transfer of the insurance policy, as well as dividends received in cash. Id. See supra note 4 (discussion of policy dividends).
68 See TEFRA, supra note 5, at § 265 (amending I.R.C. § 72(e) (1976)); see also infra notes 105-07 and accompanying text (LIFO treatment mandated by TEFRA with respect to annuity loans and withdrawals).
69 TEFRA, supra note 5, at § 265 (amending I.R.C. §72(e) (1976). The statutory authority for the preservation of cost recovery and of the testament of loans as true debt rests on the distinction between a “subsection” of the Internal Revenue Code (which is part of a section) and a “paragraph” (which is part of a subsection). Subsection 72(e) was amended
passage, also reveals no change in the favorable method of treatment for withdrawals.

If a contract does qualify as life insurance, the death benefit, for the most part, is eligible for the section 101(a) exclusion from income tax,\(^7\) and the growth of the inside build-up is tax-free.\(^7\) Until the passage of TEFRA, there was no quantitative definition of life insurance in the Internal Revenue Code. In an extreme situation, the IRS could only attack a policy on the basis of case law which required that the contract shift the risk of loss occasioned by TEFRA to provide “last - in - first out” (LIFO) treatment for accounts received. \(\text{Id.}\)

However, paragraph 72(e)(5) of the subsection provides that the “old” rule (no taxation until basis is recovered, and no recharacterization of loans as withdrawals) applies to any contract covered by that paragraph, namely, contracts entered into before August 14, 1982. I.R.C. § 72(e)(5) (1982). Section 72(e)(5)(A) states that “this paragraph,” (the cost recovery rule of paragraph 72(e)(5)), not the LIFO rule of subsection 72(e), applies to life insurance contracts. I.R.C. § 72(e)(5)(A).

\(^{70}\) I.R.C. § 101(a)(1) (1982). Section 101(a)(1) provides that generally, proceeds received as a death benefit under a life insurance contract shall not be includible in gross income. \(\text{Id.}\)

The exclusion of the death benefit from gross income for federal tax purposes is not inviolate. If there has been a transfer of the policy for valuable consideration, the beneficiary can only exclude from income that amount he or she paid for the policy, and only subsequent premiums paid. I.R.C. § 101(a)(2). Obviously, a sale of a policy from one party to another for cash is a transfer for value. But even if no cash changes hands, a transfer can be “for value.” For example, when a shareholder who owns a policy on his own life signs a buy-sell agreement with another shareholder and transfers the policy to him in return for a reciprocal promise there is clearly legal “consideration” and hence, a transfer for value. See Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961). There are two general exceptions to the sanction imposed by this rule. First, a transfer for value will not impair the exclusion, that is, the death benefit will be fully excluded from income if the transfer is to the insured himself, to a partner of the insured, to a partnership of which the insured is a partner, or to a corporation of which the insured is a shareholder or officer. I.R.C. § 102(a)(2)(B) (1982). Second, a transfer will be fully protected if the transfer gives the person who receives the policy a basis in the policy which is calculated in whole or in part with reference to the previous owner’s basis. I.R.C. § 101(a)(2)(A) (1982). See generally Brody & Leimberg, The Not So Tender Trap - The Transfer for Value Rule, J. Am. Soc’y. of C.L.U., May 1984, at 32 (discusses five “safe harbor” situations in which beneficiary can receive insurance proceeds income tax-free despite transfer of policy for value).

\(^{71}\) The proof of this negative from the plain meaning of the language has always been awkward. Before the advent of section 7702, a common explanation was that section 72 spoke only in terms of amounts “received” and the inside build-up was not actually or constructively “received” because the taxpayer could not reduce it to possession without a “substantial limitation or restriction,” namely the non-continuation of the insurance coverage. \(\text{See Treas. Reg.} \ § 1.451-2(a) (as amended 1979). See also I.R.C. \ § 72 (1982).\) With respect to insurance policies, one can now also point to section 7702(g)(1)(A) which provides that if the contract does not meet the definition of life insurance under subsection (a), the “income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.” I.R.C. § 7702(g)(1)(A) (1984). The converse of this section, therefore, is that if the contract does meet the section 7702(a) definition, the income on the contract is not treated as income in that year.
by the insured's death to the insurer and away from the insured's beneficiary and that there be a distribution of this loss among all the insureds covered.\textsuperscript{72} No mathematical "bright line" existed as to how much risk was to be shifted. Such an abusive extreme situation is illustrated by a policy on a healthy thirty-five year old which has a cash value of $99,000 and a death benefit of $100,000. This leaves the insurer in a position in which the insured receives $100,000 if he dies and $99,000 if he lives. Since the insurer is investing the $99,000 and earning a return on it, to speak of a mortality "risk" in such a situation is an absurdity.

TEFRA added section 101(f) to the code which provides that the income tax exclusion normally granted to life insurance proceeds by section 101(a) would be forfeited by a contract which both: (1) allowed flexible premium contributions rather than requiring a set premium amount each year; and (2) had a death benefit which fell below a certain percentage of the cash value.\textsuperscript{73} In 1984, section 7702 entitled "Life Insurance Contract Defined,"\textsuperscript{74} was added to the Code to further discourage contracts which were denominated as "life-insurance policies," but which had a cash value so disproportionately great in contrast to the full death benefit that the investment nature of the contract impermissibly outweighed the risk element that the insurer was undertaking. DEFRA modified the 1982 "stop-gap" definition by: (1) requiring mathematical compliance by all policies issued after 1984 and not just those having flexible premiums;\textsuperscript{75} (2) changing the sanction to the loss of tax free treatment for the inside build-up rather than the loss of tax-free treatment for the death benefit;\textsuperscript{76} and (3) for-

\textsuperscript{72} See Helvering v. Le Gierse, 312 U.S. 531 (1941). See also Commissioner v. Treganowan, 183 F.2d 288, 290 (2d Cir. 1950); Tighe v. Commissioner, 33 T.C. 557, 564 (1959) (both cases finding insurance arrangement involves shifting and distributing risk).

\textsuperscript{73} See TEFRA, supra note 5, at § 266(a) (adding I.R.C. § 101(f)). As long as the insured was age 40 or lower, the policy would qualify as life insurance if the death benefit equaled 140% or more of the cash value. For ages after 40, the 140% was allowed to decline by one percent for each year until age 75 whereupon it "froze" at 105%. See I.R.C. §101(f)(3)(C) (1982). See also Rinaldi-Sandler, Gallagher & Sherry, \textit{Coping with TEFRA in the Marketplace}, 1983 C.L.U. JOURNAL, Jan. 1983, at 14, 15-16 (discusses TEFRA rule that demands that flexible premium contracts meet one of two tests to be eligible for exclusion).

\textsuperscript{74} DEFRA, supra note 6, at § 221 (adding I.R.C. § 7702).

\textsuperscript{75} See DEFRA, supra note 6, § 221(b)(2). While the old definition for flexible contracts only applies to contracts issued between 1982 and 1984, the Tax Reform Act of 1986 contains a technical correction to DEFRA clarifying that any policy issued in 1984 which meets the current section 7702 requirements will be treated as meeting the old section 101(f) requirements. Act § 1825(d) (modifying DEFRA § 221(b) by adding new paragraph 221(b)(3)).

\textsuperscript{76} See DEFRA, supra note 6, at § 221(a) (adding I.R.C. § 7702(g)).
mulating an elaborate definition under which a policy would qualify if it complied with either of two tests.\textsuperscript{77}

Both of the tests stated in section 7702 involve actuarial concepts and computations, and it is not the purpose of this article to define them in detail.\textsuperscript{78} One test, called the "guideline premium plus cash value corridor test," is somewhat similar to the "old" test of section 101(f) in that part of it requires the death benefit to be at least a certain percentage of the cash value. The severity of congressional concern, however, is shown by the increment in that percentage: the death benefit ratio has been raised from 140\% to at least 250\% of the cash value until age 40.\textsuperscript{79} In addition, the premiums paid on the policy cannot exceed the actuarial amount defined in the statute.\textsuperscript{80} The second test, the "cash value accumulation test," requires the death benefit at all times to equal or exceed the amount which the cash value would purchase as a "net single premium" for a person of that age.\textsuperscript{81} The "net single premium" for any given dollar amount of insurance is the single amount which a person of that age would have to pay at this time to receive that given amount of coverage for the rest of his life based on the guaranteed factors in the policy. If the contract does not comply with either test, the policyholder must include, in gross income, an amount equal to the sum of the increase in the net cash surrender value of the contract during the year and the cost of the protection element less the amount of premiums paid.\textsuperscript{82} The permissibility of subtracting dividends paid to the policyholder was eliminated by a technical correction in the 1986 Act.\textsuperscript{83}

One provision which was subject to misinterpretation was Section 7702(f)(7)(B) which stated that, "[i]n the case of any change which reduces the future benefits under the contract, such change shall be treated as an exchange of the contract for another contract." This provision was construed by the Senate Committee Re-

\textsuperscript{77} DEFRA, supra note 6, at § 221(d)(3).


\textsuperscript{79} See I.R.C. § 7702(d)(2) (West Supp. 1985) (table of minimum required percentages by which death benefit must exceed cash value showing gradual decline each year of one's life).

\textsuperscript{80} I.R.C. § 7702(a)(2), (B) (West Supp. 1985).

\textsuperscript{81} I.R.C. § 7702(a)(1), (b) (1984).

\textsuperscript{82} I.R.C. § 7702(g)(1)(B) (1984).

\textsuperscript{83} Act, supra note 4, at § 1825(c) (amending I.R.C. § 7702(g)(1)(B)(ii)).
port as having the effect of reversing the cost recovery rule of section 72 thus imposing on life insurance withdrawals the same LIFO treatment which the 1982 Act had imposed on annuities.\(^4\) This interpretation was questionable for three reasons. First, it seemed inconceivable that Congress would have countenanced such a major change without clearly stating that or at least cross-referencing section 7702(f) to section 72.\(^5\) Second, the statutory language clearly indicated that the "exchange" which was deemed to occur when a withdrawal was made occurs only for the purposes of testing the policy against the definitions provided in section 7702, not for purposes of characterizing the substantive section 72 taxation of the amount withdrawn.\(^6\) Third, even if it were conceded that an exchange had been deemed to occur for all purposes, it is far from clear that the substantive law relating to exchanges of insurance policies would result in taxation whenever a withdrawal of cash accompanies the exchange.\(^7\) A compromise provision intended to


\(^6\) See I.R.C. § 7702(f) (Supp. 1985) (specifically stating that rules in said subsection apply only "for purposes of this section").

\(^7\) If a life insurance policy is exchanged for another, the transaction is a like-kind exchange eligible for section 1035 income tax-free treatment. I.R.C. § 1035(a)(1) (1982). If the policy is exchanged for a new policy plus a cash withdrawal, the transaction also falls within section 1031(b) which states that the lesser of the amount of the cash, or the amount of the "gain, if any" must be included in gross income. See id. at § 1031(b). Therefore, since section 7702(f)(7), before its amendment by the 1986 Act, purported to treat a withdrawal which reduces future benefits as an exchange, section 1031(b) would apply. See id. I.R.C. § 7702(f)(7). One possible interpretation of section 1031(b) relies on the fact that section 72(e), as stated above, only includes withdrawals in gross income when in the aggregate they exceed basis. Hence, there is no "gain, if any" until the aggregate amounts received, including those deemed received as parts of deemed exchanges, exceed the aggregate premiums. See Manno & Nolan, Internal Revenue Code Section 1035 and the Other Side of Exchange Programs, J. Am. Soc'y. of C.L.U., Nov. 1985, at 66-67. It appears, however, that the authors of the Senate Committee Report and the Joint Committee on Taxation Report did not agree with (or were unaware of) the above interpretation of the "gain, if any" language of section 1031(b). See DEFRA: JCT, supra note 45, at 654; DEFRA: SFC Explanations, supra note 84, at 578.

Specifically, those reports reflected the view of other commentators that section 72 is irrelevant to the calculation of "gain, if any" for insurance policies under section 1031(b). See Dropick, Life Insurance Exchanges Under Section 1035, 17 Conn. L. Rev. 525, 538 (1985); Stoebel, Is There a "Greene" Light for Policy Exchanges Without an Exchange? C.L.U. KEEPING CURRENT SYLLABUS, Mar. 1986, at 29, 32. These commentators indicate that if $10,000 in premiums had been paid, and the cash value had grown to $15,000, there would be $5,000 of gain and the withdrawal of $3,000 would cause gross income to be recognized
remedy this problem was appended to the 1986 Act. This provision limits LIFO treatment to "abusive" situations involving investment-oriented contracts. As a result, the reversal of the cost recovery rule applies only to withdrawals from contracts in the first fifteen policy years where the cash value before the withdrawal is "too high" as compared to the death benefit after the withdrawal, and where the withdrawal causes a reduction in the death benefit or other benefits under the policy. A formula was subsequently designed to penalize a "high cash value and low death benefit" policy.

If a policy complies with the section 7702 definition of life in-
surance by virtue of the cash value accumulation test, one ascer-
tains whether LIFO treatment will apply by doing the following
calculation during the first five policy years. First, the amount of
the death benefit which will be payable under the policy after the
withdrawal is made must be determined. A calculation must then
be made of the amount of cash value which would produce that
death benefit if the cash value was used to purchase coverage on a
net single premium basis. If the second step produces an amount
less than the actual cash value before the withdrawal, LIFO treat-
ment is imposed upon the amount of the difference.91 For policies
which qualify as life insurance under the “guideline premium and
cash value corridor” test, the amount subject to LIFO treatment
for the first five years will be measured by the greater of (1) the
amount by which the premiums paid exceed the guideline single
premium limitation before the withdrawal less the guideline single
premium for the amount of the reduction in the death benefit
caused by the withdrawal, or (2) the amount by which the cash
value before the withdrawal exceeds the post-withdrawal death
benefit divided by the cash value corridor percentage described
above.92

During policy years six through fifteen, the taxable amount for
all policies is calculated in the following manner regardless of the
definitional test with which they comply. First, determine the
amount of the new death benefit which will be payable under the
policy after the withdrawal is made. This figure is then divided by
the cash value corridor percentage applicable to the insured’s age
under section 7702(d).93 If the result is an amount less than the
actual cash value before withdrawal, income is recognized in the
amount of the difference.94 For withdrawals made after the fif-
teenth policy year, the traditional cost recovery rule will continue
to apply. There will be taxation only if the withdrawal, when
added to all other amounts previously received from the contract,
exceeds the premiums paid for the policy.95 This “adjustment pro-

will not, in any of the calculations, exceed the amount of the withdrawal, nor will it exceed
the “inherent gain” in the policy; that is, the cash value (less amounts already received)
minus the premium paid. Id. at § 7702(f)(7)(B), (C)(i).
92 See id. at § 7702(a)(1), (f)(7)(B), (C)(ii). The cash value corridor percentage is found
94 Id.
95 See id. at § 72(e); supra note 68 and accompanying text (cost recovery rule).
vision" raises a question regarding split-dollar arrangements. If the agreement is terminated before the sixteenth policy year by withdrawing an amount from the cash value sufficient to satisfy the employer's claim, then section 7702(f)(7) would presumably apply to the employer. It is possible to argue that it should not be imposed when the agreement was on the collateral assignment method because the employer is then in the position of an assignee exercising a mere security right and not of a policyholder making a withdrawal. It appears, however, that section 7702(f)(7) is triggered by a change in the policy itself and does not focus on the identity of the proper person to be taxed; thus the IRS could define the employer as having a mere recoupment right, and could then argue that the employee should be taxed because he is the policy owner. The fact that the withdrawn funds are used by the policyholder to satisfy a pre-existing obligation does not alter the substantive taxation of the withdrawal.

AMOUNTS RECEIVED FROM NONQUALIFIED ANNUITIES

A "nonqualified" annuity is essentially an annuity which a taxpayer buys on the taxpayer's own initiative with "after-tax" dollars. More specifically, the term refers to an annuity which does not include part of a retirement plan, such as an individual retirement annuity (IRA) qualified under section 408; a tax-sheltered annuity qualified under section 403(b) for the employees of tax exempt employers or state or local governments; an annuity owned by a pension or profit sharing plan qualified under section 401(a); or an annuity qualified under section 403(a) and issued in connection with such a plan.96

There are two methods by which money can be received from an annuity contract. The first method, to "annuitize" the contract, is one where payments are made at regular intervals to the annuitant over a period of time, traditionally the lifetime of the annuitant, or of the annuitant and his or her spouse.97 The date on

97 Unfortunately, the word "annuitant" is sometimes used interchangeably in the everyday speech of the insurance industry to mean the person by whose life span the payments are measured. This person may not be the same person to whom the payments are made. This imprecision is exacerbated by the Treasury Regulations to section 1035 which provide that in a tax-free exchange of annuities, the "obligee" on the old and new contract must be the same. See, e.g., Treas. Reg. § 1.1035-1 (1960). Suppose A owns an annuity on B's life. A designates C to receive the annuity payments during B's life, then designates D to receive
which these payments begin is termed the "annuity starting date" and the period of time before that date is traditionally called the "deferral period." Regularly recurring payments received after the annuity starting date are considered partially a return of basis and partially income.

To illustrate how these payments are to be taxed, let us assume that a taxpayer has paid $20,000 for a deferred "straight-life" annuity which he has chosen to annuitize when his life expectancy is twenty years. The insurance company has ascertained that it can make annual payments of $1,500. Under section 72 of the code, the taxpayer takes the "investment in the contract" ($20,000) and divides it by the "expected return" (20 x $1,500, or $30,000) to produce an "annuity exclusion ratio" of two-thirds. Under pre-1986 law, the taxpayer would then exclude two-thirds of each payment ($1,000) for as long as he might live, even if he were to live for 30 years whereupon $30,000 would be the total amount excluded from income. If the taxpayer were to die after 10 years, only $10,000 would be excluded. Consequently there was a gambling element to the exclusion.

Under the 1986 Act the exclusion ratio remains the same. However, once the dollar amount of the investment in the contract is recovered, $20,000 in the example above, all further amounts received are includible in gross income. Therefore, if the above-described annuitant lived thirty years, the last ten payments would be fully taxed. Conversely, if the annuitant died before recovering his investment, he would receive a deduction for the difference on his final income tax return. Therefore, in the example above, if any death benefit due at B's death, and finally names W to succeed to A's ownership if A dies. There are a number of obligees. The only person who is not an obligee would be B since no sums or rights are ever owed to him: his is merely the life by whose length the obligations are measured. It would be highly desirable for all involved with annuities to agree to limit the use of the word "annuitant" to the person entitled to receive income payment under the contract and to use the term "measuring life" to designate the person whose life is the subject of the contract.

99 A "straight-life" annuity is an annuity which does not have a refund or joint and survivor payment feature in case of the then annuitant's death. See C. Lownes, R. Kramer & J. McCord, FEDERAL ESTATE AND GIFT TAXES § 10.2, at 235-36 (3d ed. 1974).
100 I.R.C. § 72(b), (c)(1)-(3) (West Supp. 1987) (definitions of "exclusion ratio," "investment in the contract" and "expected return").
101 I.R.C. § 72(b) (1954).
102 See I.R.C. § 72(b) (West Supp. 1987).
103 Id. at § 72(b)(2), (3).
the taxpayer died after nine years the remaining $11,000 of his investment which was not recovered would be deductible on the final return.

The second method of receiving amounts from an annuity contract is the use of withdrawals. Prior to the 1982 Act, withdrawals made in this fashion received the same cost recovery treatment as insurance policies. An annuitant could purchase a policy for $50,000 with a deferral date far in the future, allow its cash value to grow to $100,000, then withdraw $50,000 tax free. Section 72 treated the $50,000 withdrawal on a “first-in, first-out” (“FIFO”) basis; namely, the annuitant was withdrawing his $50,000 initial investment and not the $50,000 interest growth.104

The 1982 Act imposed “last-in, first-out” (“LIFO”) treatment on withdrawals from annuity contracts. Loans from such contracts were to be treated as withdrawals and a 5% penalty on amounts which were included in gross income was exacted.105 As a result, the annuitant in the above example is now treated as if he received the $50,000 interest, not the $50,000 original basis. Section 72 states that amounts received before the annuity starting date do not enjoy the benefits of the annuity exclusion ratio, thus the full $50,000 is included as gross income. In addition, it is potentially subject to an additional 5% penalty tax.106 Initially, this penalty tax did not apply if the contract had been held over ten years before the withdrawal was made, if the taxpayer was over age fifty-nine and a half or was disabled, or if the annuitant was deceased. The penalty also did not apply if an amount received was one of a series of substantially equal periodic payments received over the annuitant’s lifetime, or received over sixty months.107 A grandfather clause further ameliorated the harshness of the new rule.108


106 See TEFRA, supra note 5, at § 266 (amending I.R.C. § 72(q) (1984)) (entitled “5 percent penalty for premature distributions from annuity contracts”).


108 Id. § 72(e)(6)(B). The grandfather rule was relatively straightforward. If a contract was purchased before August 14, 1982, the old “recovery of basis” rule applied, even to withdrawals made after that date. Id. To avoid undue complexity, the analysis in the text
DEFRA eliminated the ten-year “safe harbor” for policies issued after January 18, 1985. Amounts included in income which were not part of a series of substantially equal payments over sixty months or over the annuitant’s (or annuitant’s and spouse’s) life expectancy became subject to the 5% penalty regardless of how long the policyholder owned the annuity unless the policyholder was over age fifty-nine and a half or was disabled. Withdrawals from annuities purchased in the “TEFRA to DEFRA” period were taxed on the LIFO method and were subject to a 5% penalty tax which could be avoided if the contract were in effect for ten years. However, if such an annuity was then exchanged after January 18, 1985 for a new annuity, the ten year exemption was forfeited. Exchanges of contracts purchased before or after that corridor period did not forfeit anything.

The 1986 Act has further restricted the free availability of withdrawals by increasing the penalty to 10% of the amount included in gross income and by tightening the applicability of the penalty tax by eliminating “the payment over sixty months” exemption. The Act also imposes a retroactive penalty when (1) assumes that all annuities are single premium contracts (annuities into which one and only one payment can be made by the holder). The LIFO provision is actually applicable to withdrawals allocable to “investment in the contract” after August 13, 1982. Id. Therefore, if an annuity to which multiple contributions can be made consists of amounts paid by the taxpayer before August 14, 1982, and other amounts paid on or after that date, withdrawals are deemed to be first, a tax-free recovery of the pre-TEFRA contributions, second, a withdrawal of the interest earnings on both sets of contributions, and finally, a tax-free recovery of the post-TEFRA contributions. See Rev. Rul. 85-159, 1985-41 I.R.B. 5. In addition, even after basis was recovered, no penalty was imposed. See I.R.C. § 72(q)(2)(F) (1982) (penalty tax not applicable to distributions allocable to investment in contract before August 14, 1982). If a contract was issued after August 13, 1982 but could be traced back through any number of tax-free exchanges to an annuity issued before August 13, 1982, that annuity was also immune, since it succeeded to the status of the “pre-TEFRA annuity” for all purposes. See STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATIONS OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 365 (Comm. Print 1982).

109 See DEFRA, supra note 6, at § 222 (amending I.R.C. § 72(q)(1) (1954)).

110 See id. This age requirement and the elimination of the ten-year provision was “consistent with a general objective of the Act to encourage the use of annuities as retirement savings as opposed to short-term savings.” DEFRA: JCT, supra note 45, at 658.

111 See DEFRA: JCT, supra note 45, at 660. In contrast, if a section 1035 nontaxable exchange was effected at any time from an annuity which had been issued before August 14, 1982 or from an annuity which had been issued on or after that date pursuant to a tax-free exchange for a pre-August 14, 1982 annuity, cost recovery treatment and complete immunity from the 5% penalty would still be preserved. See id.


113 See id. at § 72(q)(2)(D) (eliminating following language: “over a period extending
distributions over the lifetime of the annuitant (or the annuitant
and spouse) begin before age fifty-nine and a half, and the mode of
payment is changed to a pattern which would not be permitted
before that age or, (2) distributions over the permissible sixty
month period began before the effective date of the 1986 abolition
of that option, and the annuitant accelerated the payment after
the effective date of the Act, even if that acceleration was to take
place when he was over age fifty-nine and a half.\textsuperscript{114} In either case,
the individual must pay an additional tax, in the year of the mode
change, equal to 10\% of all of the distributions which have been
received from the contract, including those which were originally
permitted when they were received.\textsuperscript{118}

In the case of annuities owned by corporations or trusts, the
1986 Act has created an exception to the rule that the inside build-
up of both life insurance policies and annuities is free from income
taxation. The new statute provides that as to a non-qualified annu-
ity not owned by a human being (or by the estate of a deceased
human being), the growth in its cash value must be currently in-
cluded each year in the owner’s gross income.\textsuperscript{116} This provision is
aimed at corporate-owned annuities used to provide employers
with the cash necessary to satisfy their obligations under deferred
compensation agreements entered into with employees.\textsuperscript{117}

Although this provision specifically applies only to annuities,
other provisions in the Tax Reform Act have a more subtle but
potentially important impact on life insurance owned by corpora-
tions.\textsuperscript{118} This change affects the calculation of the alternative mini-
mum tax ("\textsuperscript{\textsc{AMT}}"),\textsuperscript{119} and requires that a corporation, in calculat-

\textsuperscript{114} See id. at § 72(q)(3).
\textsuperscript{115} See id.
\textsuperscript{116} See Act, supra note 4, at § 1135 (redesignating I.R.C. § 72(u) as 72(v), and adding
new § 72(u) (West Supp. 1987)). Section 72(u) now states that for any annuity contract not
held by a natural person "the income on the contract . . . shall be treated as ordinary income
received or accrued by the owner during such taxable year." I.R.C. § 72(u)(1)(B) (West Supp. 1987).
"Income on the contract" is defined as "the sum of the net surrender value of
the contract as of the close of the taxable year plus all distributions under the contract
received during the taxable year" less the sum of "net premiums under the contract" for
current and prior years and "amounts includible in gross income for prior taxable years with
\textsuperscript{118} See I.R.C. §§ 55-59 (West Supp. 1987) (imposing and calculating alternative mini-
mum tax).
\textsuperscript{119} See id. at § 55(a)(b). The AMT is a fail-safe device for revenues. Its essential im-
port is that if the taxpayer has done an exceedingly good job of avoiding taxation, the law

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\textsuperscript{114} See id. at § 72(q)(3).
\textsuperscript{115} See id.
\textsuperscript{116} See Act, supra note 4, at § 1135 (redesignating I.R.C. § 72(u) as 72(v), and adding
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mum tax).
\textsuperscript{119} See id. at § 55(a)(b). The AMT is a fail-safe device for revenues. Its essential im-
port is that if the taxpayer has done an exceedingly good job of avoiding taxation, the law
ing the AMT for taxable years 1987, 1988 and 1989, will have to take into consideration any item of "book income" (income as an accountant would state it) not otherwise included in the AMT calculation. While these provisions do not specifically focus upon life insurance, it is a fact that corporate accountants indicate as an item of book income each year the excess of the cash value increase that year over the premiums paid in that year. Moreover, these accountants also include as an item of book income, in the year of the insured's death, the amount of the death benefit from the contract, to the extent that the benefit exceeds the amount already included in book income on the corporate financial statement. Therefore, for the three years noted, these amounts will have to be included in calculating a corporation's alternative minimum tax. In subsequent years, these amounts would be included in the same calculation as items which are otherwise excluded, but which increase earnings and profits.

Aside from the above-mentioned provisions relating to amounts distributed from annuities prior to death, the 1986 Act provides "forced distribution" rules regarding post-death distributions. These rules were designed to prevent the use of annuities to defer income through several generations. The relevant DEFRA section provided that at the death of the owner of an annuity, a distribution of the monies in the annuity must be made within five years (if death occurs after the annuity starting date), or at least as rapidly as they were already being paid (if death occurs before that date). The 1986 Act supplements DEFRA by providing that if the owner is not an individual, the "primary annuitant", that is, the measuring life, will be treated as the owner for purposes of determining the time at which this "forced distribution" must occur. The 1986 Act also clarifies the fact that forced distribution requires that taxpayer to re-compute his tax liability under a different method.

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120 See id. at § 56(c)(1)(A).
121 See id. at § 56(c)(1)(B), (g)(1), (4)(B)(ii) (1986). The new section 56(g)(4)(B)(ii) specifically includes in gross income the build-up in life insurance contracts. Id.
122 See id. at § 72(a) ("Required distribution where holder dies before entire interest is distributed").
123 See DEFRA, supra note 6, at § 222(b) (redesignating I.R.C. § 72(a) as § 72(t), and adding new § 72(s) (West Supp. 1987)).
124 See Act, supra note 4, at § 1826(b)(1) (adding I.R.C. § 72(S)(6),(7) (West Supp. 1987)). Section 1226(c) of the new Act also amends I.R.C. section 72(g) to clarify that the penalty there provided does not apply when the withdrawal is due to the death of the "holder" or "primary annuitant". I.R.C. § 72(g)(2)(B) (West Supp. 1987). Also granted immunity are distributions from annuities which are "qualified funding assets" used in struc-
requirements need not be met by individual retirement annuities and by contracts which are part of qualified plans.\textsuperscript{125} In addition, it confirms that the forced distribution rules apply at the death of each co-holder when there are co-owners of an annuity.\textsuperscript{126}

A further consequence of the 1986 Act, as it relates to annuities, is the treatment to be accorded to gifts of annuities. The general rule that gifts of property have no income tax consequences has been abrogated with respect to taxpayers making a gift of an annuity.\textsuperscript{127} Aside from the traditional gift tax, such taxpayers will have to pay income taxes on the difference between the cash value at the point of the transfer and the original amount paid for the contract.\textsuperscript{128}

**INDIVIDUAL RETIREMENT ACCOUNTS: DEDUCTIBILITY OF CONTRIBUTIONS**

The final text of the Tax Reform Act of 1986 sharply curtails the class of persons who can utilize IRA deductions.\textsuperscript{129} In addition,}

\textsuperscript{125} See I.R.C. § 72(e)(4)(C)(i) (1986) and § 1041 (transfer of property between spouses). The rule is applicable to contracts issued after April 22, 1987 in taxable years ending after that date. See H.R. 3838, 99th Cong., 2d Sess. § 1826(b)(4) (1986). It should be noted that the father also has a taxable gift of $38,000, assuming an available $10,000 annual gift tax exclusion and gift-splitting with his spouse. Any individual may give $10,000 in a calendar year to another individual without any federal gift tax. I.R.C. § 2503 (1982). The spouse of the donor can, however, agree to treat half of the amount of the gift as a transfer to that spouse. I.R.C. § 2513 (1982). This results in a combined $20,000 per year exclusion for a married couple even if all the property is titled in the name of one spouse.

\textsuperscript{126} See I.R.C. § 72(e)(4)(C)(i) (1986) and § 1041 (transfer of property between spouses). The rule is applicable to contracts issued after April 22, 1987 in taxable years ending after that date. See H.R. 3838, 99th Cong., 2d Sess. § 1826(b)(4) (1986). It should be noted that the father also has a taxable gift of $38,000, assuming an available $10,000 annual gift tax exclusion and gift-splitting with his spouse. Any individual may give $10,000 in a calendar year to another individual without any federal gift tax. I.R.C. § 2503 (1982). The spouse of the donor can, however, agree to treat half of the amount of the gift as a transfer to that spouse. I.R.C. § 2513 (1982). This results in a combined $20,000 per year exclusion for a married couple even if all the property is titled in the name of one spouse.

\textsuperscript{127} See id. at § 72(e)(4)(C).
a viable nondeductible IRA contribution for taxable years after 1986 was created.\footnote{130}

In reference to taxpayers who are not active participants in a qualified pension or profit sharing plan, an unmarried individual is still allowed to deduct any contributions to individual retirement accounts or annuities up to an amount of $2,000 or 100% of compensation, whichever is less.\footnote{131} Married persons also not covered by qualified plans would each be allowed this $2,000 deduction on their joint federal income tax return, providing both individuals have sufficient compensation.\footnote{132} If only one spouse had compensation in that year, the current spousal IRA deduction of $2,250 for the two spouses remains the same.\footnote{133}

As to the taxpayers who actively participate in qualified plans, an unmarried individual will still be allowed a $2,000 deduction if his adjusted gross income (“AGI”) is less than $25,000.\footnote{134} If said individual’s AGI is more than the $25,000 “applicable dollar amount,” a partial deduction will be allowed whereby the otherwise deductible $2,000 amount would be reduced by one dollar for every five dollars of the excess AGI.\footnote{135} For married individuals fil-

\footnote{130 See infra notes 145-50 and accompanying text.}
\footnote{131 See I.R.C. § 219(b)(1) (West Supp. 1987).}
\footnote{132 See id. at § 219(c).}
\footnote{133 See id. at § 1103, amending I.R.C. § 219(c)(1)(B). The Act removes an inequity of prior law. If one spouse earns a substantial income but the other earns less than $250, the aggregate amount deductible by both spouses is now maintained at $2,250. Under the Internal Revenue Code of 1954, the maximum deduction would have been $2000 plus 100% of the compensation earned by the latter spouse. See I.R.C. § 219(c)(2)(B) (1954).}
\footnote{134 See I.R.C. § 219(g)(3)(B) (West Supp. 1987).}
\footnote{135 See id. at § 219(g)(1)(2) (1988). For example, if the AGI were $30,000, the allowable deduction would be $1000. However, the new code also provides for “rounding” down the reduction to the next lower ten dollar multiple, see id. at § 219(g)(2)(C), and, if AGI exceeds
ing a joint return, if either spouse is covered by a qualified plan and both have compensation, a $2,000 deduction is allowed to each of them on their joint return if their combined AGI is less than $40,000. Between $40,000 and $50,000, the deduction would be reduced ratably with the deduction disappearing for couples with $50,000 or more in combined AGI. If only one spouse has compensation, the $2,250 combined “spousal” deduction for the couple would be allowed only in years in which their combined AGI is within the $40,000 applicable dollar amount. If the combined AGI is between $40,000 and $50,000, the deduction would be reduced ratably as above. The applicable dollar amount fully protecting the IRA deduction of a married individual who files a separate return shall be zero. Therefore, the very first dollar of adjusted gross income triggers a reduction in the $2,000 deduction amount.

In addition to these deductions, the Economic Recovery Tax Act of 1981 allowed employees to make deductible “qualified voluntary employee contributions” to qualified pension or profit-sharing plans. These were deductible under section 219 and reduced dollar-for-dollar the contribution and deduction otherwise allowable under section 219 for individual retirement accounts and annuities. The 1986 Act repeals the rules permitting these deductions.

Prior to the 1986 Act, nondeductible contributions to an individual retirement account or annuity were not allowed. If a tax-

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§35,000, no deduction is available. A de minimis rule provides, however, that if this mathematical computation results in an amount less than $200 but more than zero dollars, the deduction stays at $200. See id. at § 219(g)(2)(B) (1986).

See id. at § 219(g)(3)(B)(ii).

See id. at § 219(g)(1)(2). The rounding down and de minimis rules also apply. See supra note 135.


See supra notes 135, 137 and accompanying text.


See id. at § 219(g)(2)(A). For example, $4000 of the AGI will reduce the deduction to $1,200, and $6,000 of AGI will reduce it to $800. Id. Of great importance to a married person filing a separate return is the fact that if that taxpayer is not an active participant in a qualified plan, these rules do not apply and the person gets a full deduction even if that individual’s spouse is an active participant in a qualified plan. See id. at § 219(g)(1)(4). This is in direct contrast to the rule that if a joint return is filed, either spouse’s participation in a qualified plan puts both spouses in the “covered” category. See supra note 136 and accompanying text.

See ERTA, supra note 129, at § 311.

Act, supra note 4, at § 1101(b)(1) (amending I.R.C. § 219(e) (West Supp. 1987)).
payer made a contribution that exceeded the allowable deduction, that amount constituted an "excess contribution" under section 4973(b) of the Code. These excess contributions were subject to a 6% penalty tax each year that they remained in the IRA thus assuring that generally, taxpayers made the contributions only when a deduction was available. This rule remains in effect under the new Code albeit with an exception allowing nondeductible contributions for persons who are partially or wholly denied deductions under the above rules for taxable years after 1986. Any contributions in excess of the total deductible and nondeductible contributions for a taxable year will continue to be subject to the excess contributions tax. The amount of nondeductible contributions which will be allowed to a taxpayer is $2,000 (or 100% of compensation if less) less any deduction allowed under the new statutory scheme. For a married couple, this amount is $2,250 (or 100% of compensation if less) less any deductible amount when only one spouse has compensation for that year.

Nondeductible contributions must be so designated by the taxpayer and must be reported on his tax return. If this is not done, there will be a rebuttable presumption that all distributions from all IRA's are attributable to deductible contributions and hence are fully includible in the recipient's gross income. This new availability of nondeductible contributions necessarily abrogates the former rule that the tax basis of an IRA is always zero. Distributions will now have to take into consideration the fact that after-tax dollars may have been contributed by the recipient, thus creating an "investment in the contract" in the amount of these non-deductible contributions. The new Code prescribes that amounts received from an IRA will henceforth be included in, or excluded from, gross income in accordance with the annuity exclu-

144 I.R.C. § 4973(a) (1982).
145 Act, supra note 4, at § 1102 (redesignating I.R.C. § 408(o) as 408⅝ and inserting a new § 408(o) (West Supp. 1987)); Act, supra note 4, at § 1102(b)(1) (amending I.R.C. § 4973(b) (1986)).
146 See I.R.C. § 4973(b) (West Supp. 1987), as amended by Act, supra note 4, at § 1102(b)(1).
148 See id.
149 Id. at § 408(o)(1), (2), (4).
sion ratio described above. This exclusion ratio, however, is not to be calculated separately for each account or annuity, but rather in the aggregate for all IRA's held by the taxpayer.

It can be expected that the new restrictions on the deductibility of IRA contributions will cause corporate counsel to consider a section 401(k) "cash or deferred" plan as a means of doing indirectly what cannot be done directly. Granted, the 1986 Code reduces the maximum possible deduction under section 401(k) to $7,000, thus having a negative impact on these profit-sharing plans. Nevertheless, counsel should be aware that if a corporation has a qualified plan but does not currently have a section 401(k) plan at all, it may be able to provide its employees with the close equivalent of a deductible IRA by instituting a section 401(k) qualified plan allowing at least $2,000 in contributions. Under a section 401(k) plan, contributions made by the employer on behalf of the employee are excluded from the employee's gross income.

ROLLOVER CONTRIBUTIONS AND IRA DISTRIBUTIONS

Other than deductible and nondeductible contributions, the only amounts that can be placed into an IRA are certain distributions from other IRA's and other types of retirement plans. Essentially, the Code provides that certain amounts received as distributions from these plans are excluded from gross income if the

\[1. See Act, supra note 4, at § 1102(c) (amending I.R.C. § 408(d)(1)(2) (1982)). See also supra note 100 and accompanying text (definition of exclusion ratio).

\[2. See I.R.C. § 408(d)(2)(A) (West Supp. 1987) ("all individual retirement plans shall be treated as one contract"). For example, Warren Peace has contributed $2000 in each of the years 1982 through 1986 to a Maspeth Insurance Company annuity contract qualifying as an IRA and has properly deducted those amounts. For years 1987 through 1991, he contributes $2000 each year in nondeductible amounts to a Middle Village Insurance Company annuity also qualifying as an IRA. He is over age 59½ in 1992 and starts to take distributions only from the Middle Village Company annuity. At that point, using an 8% growth assumption, there is $11,733 in that account and $17,239 in the Maspeth contract. If Mr. Peace takes a distribution of $1000 his exclusion ratio is .345, that is, the $10,000 investment in the contract for all IRA's divided by the $28,972 aggregate value of all the IRA contracts and not .852 (the $10,000 investment in the contract from which the withdrawal is made, divided by the $11,733 basis in that contract alone).

\[3. See I.R.C. § 408(d)(2)(A) (West Supp. 1987) (taxation of employer contributions deferred until benefits are distributed). See also H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. 380-81 (1986) (employee not required to include in income employer contributions even if he could have elected to receive same amount in cash).

individual elects to “rollover” the sums.\textsuperscript{157} These amounts are designated rollover contributions.

With respect to qualified plan distributions, a “qualified total distribution” is allowed to be rolled over into an IRA, another qualified plan, or a 403(a) annuity.\textsuperscript{158} Such a distribution is defined as a distribution of 100\% of the individual’s account made either because of the termination of the original qualified plan (in the case of a stock bonus or profit-sharing plan, a complete discontinuance of plan contributions) or when one of the four events listed in section 402(e)(4)(A) has occurred (death, disability, age of fifty-nine and a half or above or separation from an employer’s service).\textsuperscript{159} This is to be contrasted with the treatment accorded to “partial distributions” from qualified plans. Only those partial distributions in the amount of at least 50\% of the balance of the individual’s account credited to the employee, and not made as part of a series of periodic payments, are allowed to be rolled over, and then only into an IRA.\textsuperscript{160}

A linguistic anomaly became apparent in the 1954 Code, namely, what treatment was to be accorded to a distribution of 100\% of the individual’s account made in the absence of those events which would make it a “qualified total distribution”. This form of distribution arguably qualified under the 1954 Code as a partial distribution since it was indeed a distribution of “any portion” that was not a “qualified total distribution.”\textsuperscript{161} Having satisfied the two criteria for a partial distribution, that is, more than 50\% and a lump sum for a partial distribution, the Service concluded that this was indeed a partial distribution eligible for an IRA rollover.\textsuperscript{162} This conclusion received congressional approval when section 1852 of the 1986 Act changed the pertinent phrase to “all or any portion.”\textsuperscript{163}

\textsuperscript{157} See supra note 156.
\textsuperscript{158} I.R.C. \textsection{} 402(a)(5)(A)(i) (West Supp. 1987) (transfer distribution to an “eligible retirement plan” defined in (a)(5)(E)(iv)).
\textsuperscript{159} See id. at \textsection{} 402(a)(5)(E)(i).
\textsuperscript{160} See id. at \textsection{} 402(a)(5)(D)(i)(ii).
\textsuperscript{162} See Priv. Ltr. Rul. 86-21-107 (Feb. 28, 1986). It must be noted, however, that unless the Secretary of the Treasury otherwise establishes the same principles by regulation, a private letter ruling has no official precedential status. I.R.C. \textsection{} 6110(j)(3) (1986).
\textsuperscript{163} Act, supra note 4, at \textsection{} 1852(b)(1) (amending I.R.C. \textsection{} 402(a)(5)(E)(v) (1982)). This amendment was made so as to “clarify[ ] that the distribution of the entire balance to the credit of an employee in a qualified plan may be treated as a distribution eligible for rollover under the partial distribution rollover rules so long as such distribution does not con-
For distributions made after 1986, however, this technical correction will have less of an impact. The 1986 Act allows the rollover treatment for partial distributions, with three modifications only when they are accompanied by one of the 402(e)(4)(A) events. First, it is not sufficient that the employee be over fifty-nine and a half years of age: he or she must have received the distribution on account of separation from service or disability. Second, "separation from service" will apply as a permissible event even if the individual is self-employed. Third, the election required by section 402(e)(4)(B) is pre-empted by the election required by section 402(e)(4)(A). In addition, a 1986 technical correction provision clarifies that the formerly allowed "qualified voluntary contributions" are not to be taken into account for purposes of calculating the balance to the credit of the employee under the partial distribution rollover rules.

Another advantage to taxpayers, as conclusively stated by the Service, that IRA distributions may now commence at any age as long as they are received as an annuity. Former Code section 408(f) provided that if any amount was distributed from an IRA before age fifty-nine and a half, a penalty tax equal to 10% of the amount included in gross income would be imposed; the mode of payment being irrelevant. This provision has now been repealed by section 1123(d) of the 1986 Act which places IRA's under the more general provisions of the new Code subsection 72(t). The IRS's conclusion was based upon the fact that this new Code provision exempts from this penalty tax any distributions which are "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his beneficiary . . . ."

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165 Id.
167 See IRS Announcement 87-2, 1987-2 IRB.
168 See I.R.C. § 72(t) (West Supp. 1987). This subsection, entitled "10 Percent additional tax on early distributions from qualified retirement plans", refers to I.R.C. § 4974(c), which includes IRA's in the definition of "Qualified Retirement Plans." Id. at § 72(t)(1).
169 See id. at § 72(t)(2)(A)(iv). Since subsection 72(t)(2)(A), entitled "Certain exceptions not to apply to individual retirement plans," does not make reference to 72(t)(2)(A)(iv), this exception is valid for an IRA. See IRS Announcement 87-2, 1987-2 IRB. Furthermore, this annuity like payment exemption for IRAs is not contingent upon the em-
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The new Act also modifies the TEFRA prohibition against investment of IRA assets in "collectibles" by allowing investment in gold and silver coins issued by the United States government. The technical corrections portion of the Act reiterates that whether a person is actively working or retired, distributions for his IRA must begin no later than April first of the year following the year in which the annuitant reaches age seventy and a half. The same section also resolves an important uncertainty by mandating that distributions from an IRA are subject to the "incidental death benefit requirement" to which qualified plans are subject. These limitations essentially state that the present value of the payments to be made to the individual during life must exceed one-half the present value of the aggregate payments which will be made to that individual and his death benefit beneficiary.

CONCLUSION

Significant changes have occurred in the area of taxation of life insurance, annuities and IRA's owing to the enactment of the 1982, 1984 and 1986 tax acts. These pieces of legislation have made a great deal of the old learning obsolete. To understand these new patterns is to be able to guide clients through the tax consequences of actions which impinge on such central concerns as financial security and the duty to care for one's dependents.

As highlighted herein, the change in the treatment of the deductibility of interest on a life insurance policy loan has been anything but gradual. This revolution has culminated in the 1986 Act's elimination of all "personal interest" deductions. Likewise, a corporate taxpayer's ability to deduct policy loan interest is now subject to a dollar limitation. Withdrawals from the cash value of an employee's separation from service as in the case of the other "qualified retirement plans. See I.R.C. § 72(b)(3) (1986) (separation of service provision not applicable to IRAs).  

170 See Act, supra note 4, at § 1144 (amending I.R.C. § 408(m)(3) (1982). Otherwise the acquisition of "collectibles" by an IRA is treated as a distribution from such account "in an amount equal to the cost to such account of such collectible." I.R.C. § 408(m)(1) (West Supp. 1987).

171 See id. at § 1852(a)(1)(B) (amending I.R.C. § 408(a)(6) (1982)). See generally Consentino, Minimizing Income Tax on IRA Distributions While Avoiding Estate Tax Still Possible, ESTATE PLANNING 292, 293-94 (Sept.-Oct. 1986) (when planning post-death IRA distributions one should consider person or entity to receive such distributions and manner of said payment).

life insurance policy have undergone substantial changes in their tax treatment, particularly in light of the statutory definition of life insurance added by the 1984 Act. Most importantly, however, the statutes preserve the tax-free nature of the inside build-up.

Similarly, distributions received from annuities have encountered numerous changes. In addition, withdrawals from annuity contracts no longer receive cost recovery treatment since the 1982 Act and are subject to a penalty tax in certain cases. Forced distribution rules need also be noted with respect to post-death distributions.

Finally, IRA's, and the tax treatment thereof, have been especially affected by the 1986 Act. Deductions of contributions made thereto by taxpayers actively participating in other qualified plans may now be subject to limits based on adjusted gross income. Some taxpayers affected by this limitation may nevertheless be permitted to make non-deductible contributions to their IRA's without subjecting themselves to an "excess contributions" penalty tax. Furthermore, clarifications and other changes have been made by the 1986 Act with respect to the ability to "rollover" distributions to IRA's.

This article has attempted to fully discuss these and other related issues in order to facilitate a practitioner's understanding of a complex and ever-changing area of the law. It is the author's hope that one's reading hereof will result in more informed advice for one's clients.