UNIVERSITY OF CALIFORNIA, HASTINGS COLLEGE OF THE LAW

FEDERAL INCOME TAXATION

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PROFESSOR HEATHER M. FIELD

Basic Answers to Refresher Problem #3 – Life Insurance & Annuities

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PLEASE NOTE THAT THE ANSWERS PROVIDED HEREIN ARE VERY LIMITED IN SCOPE AND ARE PROVIDED SOLELY SO STUDENTS CAN DETERMINE IF, IN GENERAL, THEY ARE APPLYING THE RELEVANT PROVISIONS CORRECTLY. THIS IS NOT, AND SHOULD NOT BE USED AS, AN EXAMPLE OF HOW TO ANSWER AN EXAM QUESTION.

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1. Denny, who died in the current year, had two life insurance policies.

   - Policy #1 will pay $87,000 in cash to Father this year.
   - Policy #2 is a $1,000,000 policy, and Denny's fiancé, Izzie, is the beneficiary. Izzie and the insurance company agree that the proceeds of Policy #2 will not be paid out to Izzie in the current year. Instead, the insurance company will retain the money and pay Izzie $60,000 per year for the rest of her life. Assume Izzie has a 40 year life expectancy.

   Father has a bit of a spending problem, and he wants to make sure that he has enough money to last him the rest of his life. For $80,000, he buys a single-life annuity with no refund feature. Under the annuity contract, he will receive $6,000 per year for life. Assume Father has a 20 year life expectancy.

What portion of the insurance payments and annuity payments will be subject to federal income tax? Assume that Izzie and Father both live for 30 more years.

Policy #1

⇒ *Not taxable. Fully excluded under §101(a)(1).*

Policy #2

⇒ *$1,000,000 total excluded amount ÷ 40 year life expectancy = $25,000 of each payment will be excluded from income. §101(d)*

⇒ *The remaining $35,000 of each payment will be included in Izzie's gross income. §101(d)*

⇒ *If Izzie dies before she recovers the full $1,000,000 excluded amount, neither she nor her estate will get a deduction for the unrecovered portion of the $1M policy.*

Father's Annuity

- ⇒ *$80,000 total investment in annuity contract ÷ $120,000 total expected return under the annuity contract (i.e., $6K/year * 20 years) = 2/3 of each payment will be excluded from income. §72(b)*
- ⇒ *Of each $6,000 payment for years 1-20:*
  - *$4,000 will be excluded from income. §72(b)(1)*
  - *$2,000 will be included in Father's gross income. §72(a)*
- ⇒ *If Father outlives his life expectancy, 100% of each payment made in years 21 and beyond will be included in Father's gross income. §72(b)(2)*

2. When Izzie became a doctor at Medical Corporation, Izzie owned a paid-up $200,000 3-year term life insurance policy on her life. Knowing that Medical Corporation likes to have life insurance policies on all of Medical Corporation's doctors, Izzie offered to sell her existing policy to Medical Corporation for $5,000.

Taking only federal income tax consequences into account, should Medical Corporation buy this life insurance policy from Izzie? Assume that Medical Corporation can purchase an equivalent policy directly from an insurance company for the same $5,000 cost.

- ⇒ *No. From a tax perspective, Medical Corporation would be better off buying the new insurance policy directly from the insurance company. Under such a policy, if Izzie dies during the term, Medical Corporation would be able to exclude all of the proceeds of the policy from income. §101(a)(1). In contrast, if Medical Corporation buys the policy from Izzie and Izzie dies during the term, §101(a)(2) would limit Medical Corporation's exclusion to the sum of (i) the $5,000 Medical Corporation paid Izzie for the policy and(ii) the amount of any subsequent premiums paid by Medical Corporation on the policy.*