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Termination of Life Insurance Policy with Loans in Excess of Basis Triggers Gain

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Sometimes a client owns life insurance and borrows against the policy in order to pay premiums. After many years of this, it is not unusual for the loans against the policy to exceed the owner's basis in the policy. If the policy is then terminated (ie, the client surrenders the policy or just stops paying the premiums), the client often is surprised to learn that the termination triggers income tax on the difference between the amount of the outstanding loan and the basis in the policy.

The seminal case on this issue is *Atwood v Comm'r* (TC Memo 1999-61). In Atwood, the Tax Court found that when the policy is disposed of (surrender, lapse or life settlement), the relief of the outstanding liability is tantamount to a cash distribution and is therefore taxable to the extent it exceeds basis.

In a recent appellate level decision, the 10th Circuit affirmed a Tax Court decision on the same issue. *McGowen v Comm'r*, 108 AFTR 2d 2011-6063 (10th Cir 2011), aff'g TC Memo 2009-285. In this case, the taxpayer purchased a single premium life insurance policy in 1986. By 2004, the loan on the policy exceeded its cash value. The insurance company notified the taxpayer that she needed to make a minimum payment on the loan in order to keep the policy in force. The taxpayer failed to make any payment, and the insurance company cancelled the policy and sent a 1099 reflecting over $500,000 of taxable income. The taxpayer claimed that the income was cancellation of indebtedness ("COD") income and excludible because she was insolvent at the time. But the Tax Court disagreed, finding that the debt was not discharged but rather was repaid in effect by transferring an appreciated asset (the built-up cash value of the policy). The 10th Circuit affirmed, finding that the taxpayer was not insolvent at the time the policy was terminated.

These cases usually involve inadvertent terminations of the life insurance policy, and this was the case in *McGowen* where the taxpayer likely ignored the insurance company's notices about the consequences of a policy termination. If a client is aware of this issue, there may be viable alternatives to prevent such an adverse result, such as keeping the policy in force until death but significantly reducing the death benefit so that the premiums are significantly reduced.

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