Tax Consequences of Terminating Whole Life Insurance with Existing Policy Loans

TAX SECTION

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Whole life insurance, when distinguished from term life insurance, has several qualities that may create surprising tax results. One of these potential pitfalls can arise when taxpayers take out policy loans on their whole life policies. These loans, when received by the taxpayer, are not taxable income so long as they do not exceed the amount paid in premiums and a termination event does not occur. Prepaying such a loan is usually not mandatory, as any debt outstanding upon the insured's death will be deducted from the policy payout to beneficiaries.

While these are helpful benefits, they can be double-edged if the taxpayer is forced to surrender the policy or if it lapses. In either of these cases, the loan (plus accrued interest) is taxable, and a Form 1099-R will be issued. This income is cancellation of indebtedness income consistent with **Tufts** and its progeny, as explained by the Tax Court in **Mallory v. Commissioner**, T.C. Memo 2016-110.

In **Mallory**, the taxpayers were issued a Form 1099-R in the amount reflecting the difference between the policy loans and the premiums paid on their recently terminated whole life insurance policy. The court concluded the insurance company properly computed the cancellation of indebtedness income, consistent with **Tufts**, to be the difference between the amounts loaned against the policy and the premiums paid. The Mallorys failed to report that income on their tax return. However, they did attach the form with a note stating: "No one knows how to compute this using the 1099R . . . IRS could not help when called." The Tax Court did not grant leniency to the Mallorys for the attached note and assessed them accuracy-related penalties under Section 6662(a) and (b)(2) for the substantial understatement of income.

The **Mallory** case is a stark reminder of the tax effects of the termination of a whole life insurance policy. The taxpayers in the case were required to include over $150,000 of ordinary income and incurred hefty penalties. Although policy loans may appear free at the time of borrowing, they generally remain in effect for the remainder of the taxpayer's life.

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