2011 MoneyGuard® Tax Question and Answers

This document represents Lincoln’s understanding of the tax laws and explains how we have implemented these laws. This document is for informational use only and should not be construed as tax advice. Lincoln strongly recommends that all policy holders seek the advice of their own tax advisor our counsel regarding tax questions.

Overview
The MoneyGuard® series of products require different tax reporting than other life insurance products because of combination of benefits provided in the contract (Life/LTC). Since the inception of MoneyGuard®, clients may have received 1099-R documents annually because the long-term care rider charges within the contract are funded through distributions from the underlying policy. These distributions were previously reported as taxable income to the extent they were paid from gain in the contract.

Effective January 1, 2010, certain provisions enacted as a part of the Pension Protection Act of 2006 (PPA) became effective and changed how these distributions are reported for federal income tax purposes, if certain criteria is met. The cost of the long-term care rider charges is no longer considered to be a distribution of taxable income, even when such cost is paid from the gain within the contract.* Instead, the cost is treated as a distribution of the cost basis in the contract first, and then as a non-taxable distribution of the gain in the contract.

The rider charges will be reported on a 1099-R with a distribution code ‘W.’ The distribution code ‘W’ refers to “charges or payments for purchasing qualified long-term care insurance contracts under combined arrangements.” While the 1099-R shows a Gross Distribution in Box 1, the verbiage on the 1099-R states “If a charge or payment was made against the cash value of an annuity contract or the cash surrender value of a life insurance contract for the purchase of qualified long-term care insurance, an amount will be shown in this box and Code W will be shown in box 7. You need not report these amounts on your tax return.”

*The PPA Act changes did not affect policies that have Long-Term Care riders that were issued prior to January 1, 1997 or any riders that are not tax-qualified. In those two scenarios, the long-term care rider costs may be taxable. The rider costs will be taxable if the cost of the rider is taken from the gain in the contract. On policies that are not Modified Endowment Contracts (MECs), the rider charges will come from the basis first and then the gain. On policies that are MEC, the rider charges will come from the gain first.
Questions and Answers

In previous years, I never received a 1099-R from Lincoln. I thought the PPA created a more favorable tax treatment for these policies, so why am I now getting a 1099?
The PPA added section 6050U to the Internal Revenue Code, which requires the payor (Lincoln) to report these charges to the IRS. As stated above, these charges are not treated as distributions of taxable income for federal income tax purposes, but Lincoln is required report them to the IRS.

Why did I receive a 1099-R when I received no distributions from your company?
The policy includes a rider that provides long-term care benefits. The cost for these riders are paid through distributions from the cash surrender value of the contract.

In previous years, I received a 1099-R from Lincoln reporting a taxable event. Why is this no longer the case?
Prior to January 1, 2010, the tax laws treated the cost of the long-term care riders in your policy differently. Because the cost is funded through cash value distributions, the rider charges were taxable in previous years if they were paid from a gain in the contract. Based on the PPA changes described above, these charges are no longer treated as distributions of taxable income even if they are paid from a gain in the contract.

Will I receive a 1099-R next year?
Yes. You will continue to receive 1099-Rs from Lincoln reporting the charges for the long-term care riders. They will show a distribution code ‘W’ if the rider meets certain criteria. Please be advised that other transactions such as withdrawals, loans and surrenders may cause a taxable event that would be reported on a form 1099-R.

Can you determine what will be reported on my 1099-R next year?
No, we are unable to determine what amount your 1099-R will include next year because we cannot predict the policy cash value and basis, the two values used to calculate gain in the policy.

Why did I receive a 1099-R when I surrendered the policy?
If the value of the policy upon surrender exceeded the cost basis in the contract, the gain in the policy is reported as a taxable amount.
Why did I receive a 1099-R with $0.00 taxable amount when I exchanged my policy for a policy issued by another insurance company?
Your policy exchange was treated as a non-taxable exchange under Internal Revenue Code Section 1035. The distribution is reportable, but does not cause you to recognize the gain in the contract. The distribution code on the 1099-R is code ‘6’ to signify that the exchange qualifies as a section 1035 exchange.

Why am I subject to a 10% penalty based on the taxable amount of the distribution reported on my 1099-R?
If your policy is a MEC (modified endowment contract) and you are under age 59 ½ at the time the distribution was made, your distribution is subject to a 10% penalty (unless certain exceptions apply). The distribution code ‘1’ found on the 1099-R indicates that the distribution is a “pre-mature” distribution and subject to the 10% penalty.

Why did I receive a 1099-R when I took a loan from my policy?
Your policy is a MEC (modified endowment contract) and there was a gain in your policy when the loan was taken.

Why does my 1099-R report accrued loan interest as a taxable distribution?
Your policy is a MEC (modified endowment contract) and you did not pay the loan interest that was due on the policy’s anniversary or within the grace period allowed under your policy’s provisions. Consequently, the loan interest is added to the current outstanding loan balance, and is taxable to the extent of gain in the contract because it is viewed as a new loan under these circumstances.

Why did I receive a 1099-R when I took a partial withdrawal from my policy?
Your withdrawal was reported as taxable income because there was a gain in your policy when your distribution was taken.

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