

## **The Dangers of Borrowing on Life Insurance**

**Take-Away:** Borrowing against a life insurance policy's cash surrender value can sometimes lead to phantom taxable income if the debt owed exceeds the policy's cash surrender value.

**Background:** Sometimes the owner of a cash surrender value life insurance policy will take loans against the cash surrender value, either for the payment of premiums, such as through an automatic premium loan option, or simply a loan, often to deal with unanticipated financial challenges in a closely held business. Immediate access to the cash surrender values of the life insurance policy is clearly a benefit, but the outstanding loans can create problems when the policy is subsequently terminated. Consider the following case:

### ***Jonathan Sawyer v. Commissioner, Tax Court Memo 2026-33 (April 16, 2026)***

**Facts:** Jonathan was the CEO of a family printing business. In 1982 Jonathan purchased a \$200,000 life policy on his own life from Northwestern Mutual. The purpose of the policy was to provide for his wife in the event of his untimely death. Jonathan elected an automatic premium loan option, which allowed Northwestern to secure premium payments by borrowing against the policy's cash surrender value to prevent the policy from lapsing. In 2009 Jonathan borrowed \$80,000 from the policy, secured by the value of the policy, which he used to help his closely held business. Despite that infusion of cash, the business liquidated in 2010. In 2015 the combined balances of the \$80,000 loan and the accumulated premium loans eclipsed the policy's cash surrender value. Accordingly, Northwestern automatically terminated the policy. At the time of the policy cancellation the policy cash surrender value was \$205,433, which Northwestern used in its entirety to satisfy the outstanding principal and interest of the loans. Jonathan's investment in the policy was \$44,533.

**Dispute:** This satisfaction of the loans resulted in a taxable distribution to Jonathan of \$160,900 which was reported by Northwestern on Form 1099-R. Jonathan thought the Form 1099-R was inaccurate, so he did not file a 2015 federal income tax return prompting the IRS to in turn prepare a substitute for return and issue a Notice of Deficiency. [IRC

6020(b).] Jonathan challenged the IRS Notice of Deficiency claiming that the now-defunct closely held business actually owned the policy at the time of its termination, so that if taxes were owed, they were owed by the business, not him personally. Jonathan then argued that he should not be taxed on the deemed distribution because he received no actual cash when the policy was terminated. As an alternative argument, Jonathan argued that if the distribution was taxable, he should be entitled to deduct the interest paid on the loans as investment interest since they were load to investments. [IRC 163(h)(2)(B).]

### **Tax Court Decision:**

**Policy Ownership:** Jonathan testified that he had directed the business bookkeeper to transfer ownership of the policy to the business. The Court noted that the policy itself required written proof of the transfer to be received by Northwestern for any policy assignment to be effective. Northwestern never received any paperwork to this effect, and it continued to address all correspondence to Jonathan regarding the policy. Consequently, the Court concluded that the ownership remained with Jonathan, not the business.

“The reality of the transaction was that Mr. Sawyer personally borrowed from Northwestern, then made a corresponding capital contribution to [the business.]”

**Taxation on Policy Termination:** IRC 72(e)(5) provides that gross income includes nonannuity amounts received under a life insurance contract in excess of the investment in the contract. While Jonathan argued that he received no cash when the policy was terminated, the Court noted several precedents that a taxpayer must recognized indirect distribution of an insurance policy’s cash surrender value as gross income when used to extinguish policy debt.

“Although [Jonathan] did not receive any cash, the entirety of the policy’s value having been applied against the outstanding loans, he is nonetheless treated as having received a taxable constructive distribution of \$160,900..The loan repayment is treated as if the cash value of the policy was transferred to [Jonathan] and he in turn repaid the outstanding loan.”

**Business Interest Deductibility:** Under IRC 163(h) an individual may not deduct personal interest, but there is an exception for investment interest. [IRC 163(h)(2)(B).] Here, the Court accepted Jonathan's testimony that the \$80,000 loan proceeds were directly deposited into the business' back account to keep the business running, and thus he satisfied the tracing rules required by the Regulations. [Regulation 1.163-8T.] The Court went on to find that the business constituted property held for investment [IRC 163(d)(5)(A)(i) and IRC 469(e)] because business stock generally produces dividend income. Accordingly, \$40,107 in accrued interest on the \$80,000 loan was deemed deductible, subject to the net investment income limitations of IRC 163(d)(1).

**Premium Interest Not Deductible:** In contrast, the Court found that the premium loan interest was not deductible as it was nondeductible personal interest, according to the legislative history of the 1986 Tax Reform Act.

**Penalty:** The Court also sustained the addition to tax regarding the failure-to-file penalty. [IRC 6651(a)(1).] But then the Court found a proven financial hardship, in that Jonathan had exhausted his personal assets, sold his home to avoid foreclosure, and had his wages from the business garnished, and thus, due to the unforeseen nature of the phantom income caused by the policy's termination, Jonathan was relieved of the additional penalty.

**Conclusion:** There always looms the danger of borrowing against a cash surrender life insurance policy when the debt exceeds the cash surrender value, leading to policy termination, and phantom income attributed to the policy owner.

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