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Tax Planning Tips: Life Insurance

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Understanding the importance of life insurance is one thing. Understanding the tax rules is quite another. As insurance products have evolved and become more sophisticated, the line separating insurance vehicles from investment vehicles has grown blurry. To differentiate between the two, a mix of complex rules and exceptions now governs the taxation of insurance products. If you have neither the time nor the inclination to decipher the IRS regulations, here are some life insurance tax tips and background information to help you make sense of it all.

Life insurance contracts must meet IRS requirements

For federal income tax purposes, an insurance contract cannot be considered a life insurance contract--and qualify for favorable tax treatment--unless it meets state law requirements and satisfies the IRS's statutory definitions of what is or is not a life insurance policy. The IRS considers the type of policy, date of issue, amount of the death benefit, and premiums paid. The IRS definitions are essentially tests to ensure that an insurance policy isn't really an investment vehicle. The insurance company must comply with these rules and enforce the provisions.

Keep in mind that you can't deduct your premiums on your federal income tax return

Because life insurance is considered a personal expense, you can't deduct the premiums you pay for life insurance coverage.

Employer-paid life insurance may have a tax cost

The premium cost for the first $50,000 of life insurance coverage provided under an employer-provided group term life insurance plan does not have to be reported as income and is not taxed to you. However, amounts in excess of $50,000 paid for by your employer will trigger a taxable income for the "economic value" of the coverage provided to you.

You should determine whether your premiums were paid with pre- or after-tax dollars

The taxation of life insurance proceeds depends on several factors, including whether you paid your insurance premiums with pre- or after-tax dollars. If you buy a life insurance policy on your own or through your employer, your premiums are probably paid with after-tax dollars.

Different rules may apply if your company offers the option to purchase life insurance through a qualified retirement plan and you make pretax contributions. Although pretax contributions offer certain income tax advantages, one tradeoff is that you'll be required to pay a small tax on the economic value of the "pure life insurance" in the policy (i.e., the difference between the cash value and the death benefit) each year. Also, at death, the amount of the policy cash value that is paid as part of the death benefit is taxable income. These days, however, not many companies offer their employees the option to purchase life insurance through their qualified retirement plan.

Your life insurance beneficiary probably won't have to pay income tax on death benefit received

Whoever receives the death benefit from your insurance policy usually does not have to pay federal or state income tax on those proceeds. So, if you die owning a life insurance policy with a $500,000 death benefit, your beneficiary under the policy will generally not have to pay income tax on the receipt of the $500,000. This is generally true regardless of whether you paid all of the premiums yourself, or whether your employer subsidized part or all of the premiums under a group term insurance plan.

Different income tax rules may apply if the death benefit is paid in installments instead of as a lump sum. The interest portion (if any) of each installment is generally treated as taxable to the beneficiary at ordinary income rates, while the principal portion is tax free.

In some cases, insurance proceeds may be included in your taxable estate

If you hold any incidents of ownership in an insurance policy at the time of your death, the proceeds from that insurance policy will be included in your taxable estate. Incidents of ownership include the right to change the beneficiary, the right to take out policy loans, and the right to surrender the policy for cash. Furthermore, if you gift away an insurance policy within three years of your death, then the proceeds from that policy will be pulled back into your taxable estate. To avoid having the policy included in your taxable estate, someone other than you (e.g., a beneficiary or a trust) should be the owner.

Note: If the owner, the insured, and the beneficiary are three different people, the payment of death benefit proceeds from a life insurance policy to the beneficiary may result in an unintended taxable gift from the owner to the beneficiary.

If your policy has a cash value component, that part will accumulate tax deferred

Unlike term life insurance policies, some life insurance policies (e.g., permanent life) have a cash value component. As the cash

value grows, you may ultimately have more money in cash value than you paid in premiums. Generally, you are allowed to defer income taxes on those gains as long as you don't sell, withdraw from, or surrender the policy. If you do sell, surrender, or withdraw from the policy, the difference between what you get back and what you paid in is taxed as ordinary income.

You usually aren't taxed on dividends paid

Some policies, known as participating policies, pay dividends. An insurance dividend is the amount of your premium that is paid back to you if your insurance company achieves lower mortality and expense costs than it expected. Dividends are paid out of the insurer's surplus earnings for the year. Regardless of whether you take them in cash, keep them on deposit with the insurer, or buy additional life insurance within the policy, they are considered a return of premiums. As long as you don't get back more than you paid in, you are merely recouping your costs, and no tax is due. However, if you leave these dividends on deposit with your insurance company and they earn interest, the interest you receive should be included as taxable interest income.

Watch out for cash withdrawals in excess of basis--they're taxable

If you withdraw cash from a cash value life insurance policy, the amount of withdrawals up to your basis in the policy will be tax free. Generally, your basis is the amount of premiums you have paid into the policy less any dividends or withdrawals you have previously taken. Any withdrawals in excess of your basis (gain) will be taxed as ordinary income. However, if the policy is classified as a modified endowment contract (MEC) (a situation that occurs when you put in more premiums than the threshold allows), then the gain must be withdrawn first and taxed.

Keep in mind that if you withdraw part of your cash value, the death benefit available to your survivors will be reduced.

You probably won't have to pay taxes on loans taken against your policy

If you take out a loan against the cash value of your insurance policy, the amount of the loan is not taxable (except in the case of an MEC). This result is the case even if the loan is larger than the amount of the premiums you have paid in. Such a loan is not taxed as long as the policy is in force.

If you take out a loan against your policy, the death benefit and cash value of the policy will be reduced.

You can't deduct interest you've paid on policy loans

The interest you pay on any loans taken out against the cash value of your life insurance is not tax deductible. Certain loans on business-owned policies are an exception to this rule.

The surrender of your policy may result in taxable gain

If you surrender your cash value life insurance policy, any gain on the policy will be subject to federal (and possibly state) income tax. The gain on the surrender of a cash value policy is the difference between the gross cash value paid out (plus any loans outstanding) and your basis in the policy. Your basis is the total premiums that you paid in cash, minus any policy dividends and tax-free withdrawals that you made.

You may be able to exchange one policy for another without triggering tax liability

The tax code allows you to exchange one life insurance policy for another (or a life insurance policy for an annuity) without triggering current tax liability. This is known as a Section 1035 exchange. However, you must follow the IRS's rules when making the exchange.

When in doubt, consult a professional

The tax rules surrounding life insurance are obviously complex and are subject to change. For more information, contact a qualified insurance professional, attorney, or accountant.

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