Tax Issues Associated With Life Insurance

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Most everyone believes life insurance is tax free. However, technically, the Internal Revenue Code deems life insurance to be an exception to the income tax provisions, and as with every legal rule, there are exceptions to the exceptions. Thus, it comes as a surprise to some people when they find out life insurance proceeds are not always tax free. Unfortunately, most people do not discover this until after a death, in which case it is too late to avoid the tax.

Below are five tax issues to be cognizant of when you are dealing with life insurance.

1. ESTATE TAX

In certain situations, life insurance proceeds may be subject to federal estate tax as well as possibly state tax. The general rule is that if the life insurance policy is owned by the decedent or if the decedent had "incidents of ownership," the life insurance proceeds are included in the decedent's gross taxable estate. Examples of incidents of ownership include a person maintaining the right or an interest in the policy such that they can modify the policy, borrow cash value from the policy, or benefit from the proceeds of the policy.

For example, a life insurance policy is owned by Peter, the life insured is Peter's, and the beneficiary of the policy is Peter's brother, James. Even if there is no state tax, for federal estate tax purposes the life insurance proceeds are includable in Peter's taxable estate. This is significant because if the other assets Peter owns at his death place him close to or above the federal estate tax applicable exclusion amount, the life insurance proceeds may cause, or significantly increase, federal estate taxes due upon Peter's death.

To enhance this example, if the life insurance policy on Peter's life was to pay $1.5 million in proceeds and the other assets in Peter's estate totaled $3 million, for federal estate tax purposes Peter's gross taxable estate would be $4.5 million. If Peter were to die in 2009, $1 million would be subject to federal estate tax in the amount of $450,000.

2. INCOME TAX

Believe it or not, sometimes life insurance proceeds may be subject to income tax as well. If there are any lifetime distributions of the policy's cash surrender value greater than the owner's basis in the policy, the amount of money received above that basis is taxable income. The basis in a policy is the amount of money paid for the premiums and any other consideration paid to purchase the policy. Therefore, any distributions made by the life insurance company to the owner of the policy that exceed the owner's basis are potentially subject to income tax.

For example, Peter owns a life insurance policy with a cash surrender value of $30,000. Since the inception of the policy, Peter has paid premiums equaling $10,000, which is Peter's basis. If Peter were to receive distributions from the life insurance company equal to $20,000, Peter would pay income tax on the $10,000 above his basis.

3. FORGIVENESS OF LOAN

Keeping the previous example in mind, income tax is often avoided by having Peter sign a promissory note to repay the $10,000 loan, the amount above Peter's basis. If Peter then cancels the policy and the life insurance company forgives the $10,000 loan, the forgiveness of the loan has provided Peter with something of "value," which is the elimination of Peter's obligation to repay the loan. Since Peter has received something of "value," he has essentially received $10,000 of income which will be subject to income tax.

4. GIFT TAX

In certain circumstances, life insurance proceeds may be subject to gift taxes. If the owner of a life insurance policy is Peter's daughter, the insured is Peter, and the beneficiaries are Peter's daughter and son, a gift tax would apply to the proceeds received by Peter's son.

This arrangement often occurs when people try to avoid having the insurance proceeds included in the parent's taxable estate. If Peter provided his daughter with the money to pay for the premiums of the policy and the amount is less than the annual gift exclusion, he avoids any gift tax while he is alive. However, when Peter dies, the fact that his daughter owns the policy and she names her brother as a beneficiary will cause the IRS will treat her brother's receipt of proceeds as a taxable gift to her because it comes from his sister who is now the donor.

5. TRANSFER FOR VALUE RULE

The tax-free status of life insurance can be defeated if you run afoul of the "transfer for value rule." In essence, the transfer for value rule was imposed by the IRS to prevent people from speculating on human life where persons with no "insurable interest" would receive insurance proceeds at the death of another. People who have an insurable interest generally include a spouse, children, parents, and co-shareholders in a closely held business. Nevertheless, there may be situations

where you transfer the ownership of a life insurance policy for value to a party with no insurable interest in your life, and in doing so, income tax is paid by the beneficiaries. As you can imagine, there are exceptions to this exception which will be explained in more detail in another section. However, below is an example of a transfer for value situation that would defeat the tax exemption of life insurance.

Assume Peter is the owner of a $1 million life insurance policy. Peter is the insured, and the beneficiary is Peter's son. If Peter sells his life insurance policy to his friend, James, for $25,000 and James acquires the right to name himself as the beneficiary, a transfer for value has occurred. James is not related to Peter, and James is not associated with Peter in some business manner. After Peter dies, James collects the life insurance proceeds of $1 million. However, that $1 million is taxed as income to James because of the transfer for value rule.

CONCLUSION

As you can see, it is extremely important for you to consult with an attorney to determine if your life insurance will be received tax-free by your beneficiaries. Each situation has its own facts and, by consulting the appropriate professionals you can minimize or avoid taxation of proceeds.

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