Taxation and Life Insurance

What is it?

Life insurance has long been recognized as a useful and relatively simple way to provide for your heirs and loved ones when you die. If your survivors relied on your income during your lifetime, then they will be able to avoid financial difficulties after your death if your life is adequately insured. Lawmakers have long recognized the social usefulness of life insurance, which helps protect widowed spouses and children and keeps them off of public assistance. Accordingly, lawmakers have historically provided liberal tax benefits as an incentive to those who put their hard-earned dollars into life insurance policies.

Favorable tax treatment also extends to accumulations within certain cash value life insurance. Generally, when you pay premiums on a cash value life insurance policy, some of your money is applied toward the policy cash value, which is similar to a savings account within the policy. Over time, cash values accumulate tax deferred as long as certain requirements are met. During your lifetime, you can access the cash value by a withdrawal, policy loan, or surrender (cancellation) of the policy.

Caution: *If the policy is classified as a modified endowment contract (MEC), withdrawals, including loans and partial surrenders, will be subject to immediate taxation to the extent that the policy's cash value exceeds the premiums paid. In addition, withdrawals from a MEC made prior to age 59½ may result in a 10 percent penalty, unless an exception applies.*

Why do you need to know?

Whether you are purchasing life insurance to protect your family, as an investment, or both, the tax treatment of your policy will directly affect the return that you (or your heirs) get from the dollars you deposited with the insurer. In most cases, your insurance agent or accountant will be able to tell you everything you need to know about the taxation of your policy, but if you are involved in portfolio planning or product comparisons, you may want to become more familiar with the tax rules so that you can draw meaningful conclusions.

How is life insurance taxed?

In general, life insurance death benefit isn't taxed, but that is hardly the end of the story. Familiarity with some of the basic rules will help you avoid traps for the unwary and plan accordingly.

First, it has to be life insurance

Life insurance provides you with many tax advantages, but only if it falls within the definition of life insurance for federal income tax purposes. If the terms of a life insurance contract do not meet the statutory definition of life insurance, then you are not entitled to the special income tax treatment.

Income tax considerations

In most cases, premiums are paid with after-tax dollars. Typically, death benefits are received tax free by your beneficiaries after your death, but the sale or surrender of your cash value policy during your lifetime triggers a tax on realized gain.

Tax-free buildup of policy value

The cash buildup within permanent or cash value life insurance is not subject to income taxes if certain rules are met. There are a few rare--but important--exceptions.

Taxation of dividends

A certain type of permanent cash value insurance, whole life insurance, may pay dividends to policyowners out of the insurer's surplus earnings for the year. Whether you take the dividends in cash or keep them on deposit with the insurer, they are considered a return of your premiums. As long as you don't get back more than you paid in, you are merely recouping your costs, and the dividends are not included in income. Dividends in excess of premium payments, however, are generally taxable as ordinary income. Dividends paid by mutual life insurance companies do not qualify for capital gains tax treatment.

Taxation of benefits

Benefits can be characterized as living benefits or death benefits. The tax treatment of benefits varies depending on who receives them and how and when they are distributed.

Taxation of policy exchanges

The tax code allows you to exchange one life insurance policy for another life insurance policy without triggering current tax liability. However, tax-free treatment will apply to an exchange only if it satisfies certain requirements.