Life Insurance Taxation

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Prepared for:

How Is Life Insurance Taxed?

Because of the unique role life insurance plays in protecting people against the risk of economic loss, the federal government has extended favorable tax treatment to life insurance.

Premiums:

Generally, premiums paid for life insurance, whether paid by an individual or a corporation, are not tax deductible.

In the case of return of premium term insurance, any premiums returned by the insurance company to the policyholder are received tax-free by the policyholder.

Living Benefits:

NOTE: The following discussion assumes that the life insurance contract meets the "seven-pay test" and is not classified as a modified endowment contract (see below for information on modified endowment contracts).

Cash Value: The cash value accumulations in cash value life insurance grow on a tax-free basis until the policy is surrendered. If the policy is surrendered and the proceeds exceed the total premiums paid, the difference is taxable in the year received.

Policy Dividends: If a policy pays dividends, the dividends are considered a return of premium and are not taxable until total dividends plus all other amounts that have been received tax-free under the policy exceed an amount equal to the policyholder's basis in the contract, at which time excess dividends are taxable income. Any interest on accumulated dividends, however, is taxable in the year credited.

Policy Loans/Withdrawals: A policy loan is not considered a distribution and, as a result, is not taxable. If, however, there is an outstanding loan when the policy lapses or is cash surrendered, the amount of the outstanding loan is taxable to the extent that the policy's cash value exceeds the policyowner's investment in the contract. Cash withdrawals are tax free until the policyowner has recovered his/her investment in the contract, after which excess withdrawals are taxable income. Loans and withdrawals will reduce the policy's death benefit and cash value available for use.

Modified Endowment Contracts: A policy fails to meet the seven-pay test required by the Internal Revenue Code [IRC Sec. 7702A(a)(1)] and is classified as a modified endowment contract (MEC) if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. If the death benefit of a policy is reduced within the seven-pay testing period, there is a "look-back" provision that requires the seven-pay test to be reapplied as if the policy had originally been issued for the reduced death benefit amount. Finally, if there is a material change in a policy that originally passed the seven-pay test, the changed policy is subject to the seven-pay test and classified as a MEC if it fails that test.

If a policy fails the seven-pay test and is classified as a modified endowment contract, distributions from the policy are taxable as income in the year received to the extent that the policy's cash value before the distribution exceeds the policyowner's investment in the contract (i.e., to the extent there is gain in the policy, such gain is taxed first). Only after an amount equal to such gain is distributed can the policyowner receive his/her investment in the contract on a tax-free basis.

Death Benefits:

Income Taxes – Personally-Owned Life Insurance: Life insurance death benefits paid in a lump sum are received income tax free -- a unique and important benefit. If the death benefit is taken as income under a settlement option, there is an interest element in each payment received. The portion of each payment representing principal (the death benefit) is received income tax free and the portion representing interest is taxable.

Income Taxes – Employer-Owned Life Insurance: In the case of employer-owned life insurance, proceeds received by a business at the death of a key employee generally are not subject to the regular corporate federal income tax, assuming the following requirements are met for contracts entered into after August 17, 2006:

- Before the employer-owned life insurance contract is issued, the employee who is to be insured must be notified in writing that the employer intends to insure the employee's life. The notice must include the maximum face amount for which the employee's life could be insured, as well as state that the policyowner (the employer) will be the beneficiary of the policy's death proceeds. In addition, the employee who is to be insured must give his/her written consent to be insured by the contract and to the insurance coverage continuing after the insured employee terminates employment; **and**
- The insured must have been an employee of the employer at any time during the 12-month period prior to the date of death or have been a director or highly-compensated employee at the time the contract was issued.

Estate Taxes: If the insured held any incidents of ownership in the policy, the death benefit is included in the insured's estate for federal estate tax purposes.