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Tax Planning Tips: Life Insurance

Understanding the importance of life insurance is one thing. Understanding the tax rules is another. Learning the tax implications of your insurance may impact your plan and you might find it helpful to review how your insurance plan enables or prohibits your financial life goals.

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.

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.

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.

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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

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. If there is an interest portion, each installment is generally treated as taxable to the beneficiary at ordinary income rates, while the principal portion is tax free.

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 should be the owner.

If your policy has a cash value component

Unlike term life insurance policies, some life insurance policies 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 may 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, the difference between what you get back and what you paid in is taxed as ordinary income.

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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.

Plan Well – There are many different types of insurance and they all play a role when it comes time to file taxes. Understanding how it may change your plan may be important in reaching your financial goals.

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