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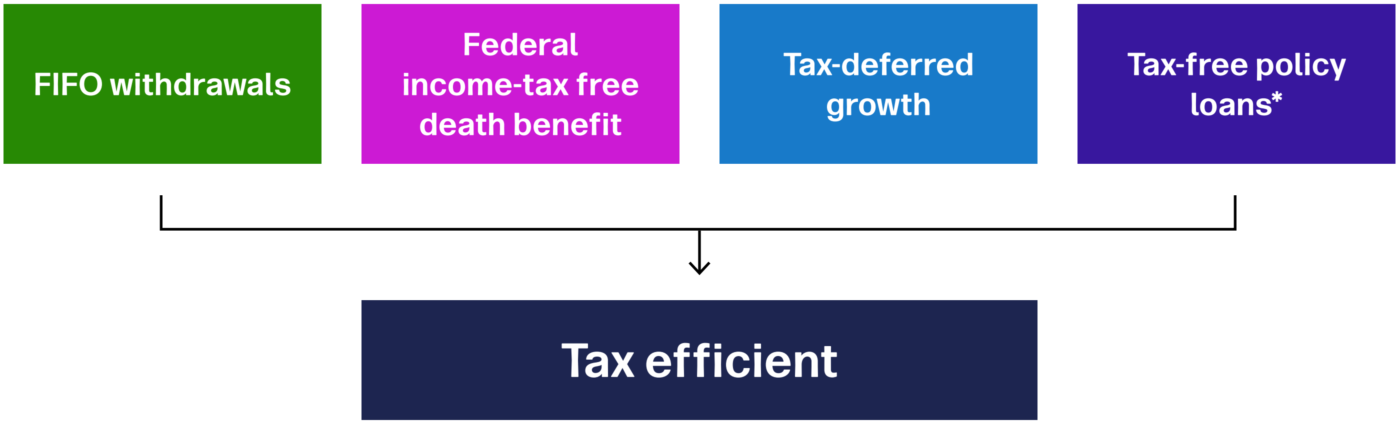
# Taxation of life insurance

**Life insurance is most commonly associated with end-of-life expenses and wage replacement, so it probably isn't what most people think about when tax season comes around. Yet properly utilized, life insurance can play a role in mitigating an overall tax burden.**




## Income tax treatment of death proceeds

Lump-sum death benefit proceeds paid to beneficiaries are generally free of federal income tax, with a few exceptions. Without proper planning, however, the value of a life insurance policy death benefit, frequently the largest asset includable in an individual's gross estate, is generally included in the calculation of the estate tax of the deceased.

* Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

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## Federal income tax treatment of proceeds during the life of the owner

The cash value buildup inside of a permanent insurance policy is not taxable as income if it is not withdrawn from the policy. Distributions of the cash value buildup inside a policy are permissible, however, and can be accomplished in several ways, including withdrawals from the cash value, loans, policy dividends, life settlements, and cash surrenders.

# Cost basis

To determine the tax consequences, if any, of a particular life insurance transaction, the policy's tax basis must be determined. Tax, or cost basis, is established by adding total premiums contributed to the policy, and subtracting any dividends paid into the policy by the insurer. Furthermore, if any withdrawals consisting of a tax-free return of the policyholder's premium have been made, such amounts subsequently reduce the cost-basis of the policy.

Cost basis = Total premiums − Dividends paid into policy by insurer AND tax-free withdrawal

### First in, first out

FIFO tax treatment is one of the key tax benefits of most cash-value life insurance policies. This treatment allows policy owners to make withdrawals from the cash-value that are attributed to premiums paid into the policy with after-tax dollars. This provides the policy owner access to the cash-value as part of a tax-free return of premium, leaving the taxable growth portion of the cash-value untouched.

### Policy loans

Many cash value life insurance policies provide the ability to borrow against the policy. These loans are received free of federal income tax, assuming the owner follows the provisions of the loan program.

Generally, policy loans have no correlation with tax basis unless the policy is a modified endowment contract. If a policy is fully surrendered, allowed to lapse, or exchanged for another life insurance, annuity, or long term care policy, however, it is taxable to the extent that the cash value exceeds the owner's tax basis in the contract.

### Policy dividends

Policy dividends are considered a nontaxable return of premium and therefore reduce the policy owner's tax basis. If combined overall dividends exceed total premiums paid into the policy, however, dividends are taxable to that extent. If policy dividends are used to lower the premium requirement or paid back into the policy to buy paid-up additions, the tax basis reduction resulting from the payment of the dividend is offset by a corresponding tax basis increase due to the dividend being treated as a premium payment for tax purposes.[1]

### Cash surrender

If a policy is fully liquidated for cash, the amount includable in taxable income is the total surrender amount, minus the current basis in the policy. It is important to note that any dividends left to accumulate at interest are not included in the surrender value for tax purposes, as they would have already reduced the basis in the contract.

[1] §72(e)(4)(b)

### 1035 exchange

Fully surrendering a cash value life insurance policy creates a taxable event when the total contract value exceeds the premiums paid into the contract. Section 1035 of the Internal Revenue Code provides, that replacing one life insurance contract for another life insurance, annuity, or long term care contract is non-taxable when certain requirements are met. The policy owner may exchange a current policy for a new policy with the same owner and same insured (insured and annuitant must be the same when exchanging for an annuity), and the exchange is executed directly through a transfer between the surrendering carrier and the receiving carrier. The policyholder cannot receive a check from the surrendering carrier and use the proceeds to purchase a new contract from the receiving carrier. This would be a disqualifying transaction resulting in a taxable event. In effect, the distribution from the surrendering carrier would be included in taxable income to the extent that the policy value exceeds premiums paid into the contract and is an irrevocable transaction.

# Transfer for value rule

The transfer-for-value rule stipulates that a policy that is transferred from one owner to another for valuable consideration of any form loses the tax-free death benefit element.

**Policy transfers that are not impacted by the transfer for value rule include[2]:**

- The transferee is the insured
- Transfers to a partner of the insured
- The transferee is a partnership in which the insured is a partner
- Transfers to a corporation in which the insured is an officer or shareholder
- Transfers in which the transferee's tax basis is determined by reference to its basis to the transferor

[2] §1.101-1(b)(1)(ii)(B)(1)

# Modified endowment contract

A life insurance policy that fails the seven-pay test is treated as a modified endowment contract (MEC) for tax purposes. The spirit of the rule is to discourage excessive premium payments into the contract that would result in a fully paid-up policy before the end of a seven-year period, preventing a potentially infinite, large-scale tax shelter. The rule limits the sum of net level premiums from exceeding an amount sufficient to guarantee all future benefits of the policy paid over seven years.
The seven-pay test is applied at policy inception, and again if there are any material changes to the policy, which include most increases and some decreases in future benefits. For instance, an increase in the death benefit amount may occur due to a flexible premium payment. It should also be noted that all single-premium life insurance policies are designated as MECs. Once a policy becomes a MEC, it will be classified as a MEC in the current year and all tax years thereafter.
A life insurance policy that is determined to be a MEC will retain its tax-deferred status, but will be subject to earnings first, recovery of basis second, or LIFO tax treatment with respect to distributions. Gains in the policy must come out first and are includable in taxable income[3], and unless an exception applies, a 10% early-withdrawal penalty will also be enforced against policy owners who are younger than 59½ to the extent of any distributed gains.[4] The MEC policy death benefit is received free of income tax.

**MEC transactions treated as LIFO[3]**

- Cash withdrawals
- Loans secured by the policy value
- Loans utilized to pay premiums or other intentions
- Accrued interest on policy loans
- Policy assignment

**MEC transactions *not* treated as LIFO[3]**

- Policy dividends utilized to purchase paid-up additions
- Surrender of paid-up additions to pay policy premiums
- Policy dividends retained by the insured to pay policy premiums

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[3] §72(e)(2)(A)(B)(i)(ii) and §72(e)(4)(A)(i)(ii)(B)

[4] §72(v)(1)(2)(A)(B)(C)