One Resource Group
13548 Zubrick Road
Roanoke, IN 46783
888-467-6755
Life_Sales@ORGCorp.com

Income Taxation of Life Insurance Benefits

August 02, 2017

Income Taxation of Life Insurance Benefits

What is life insurance?

Webster's dictionary defines life insurance as "insurance providing for payment of a stipulated sum to a designated beneficiary upon death of the insured." However, the tax code has its own definition of life insurance . If your life insurance policy qualifies under the tax code's definition, you and the policy's beneficiaries may enjoy many income tax advantages. This discussion focuses on the income tax implications surrounding life insurance benefits. For a discussion in general about the income tax implications of life insurance, see Income Taxation of Life Insurance .

What are life insurance benefits?

Life insurance benefits fall into two major categories:

- Living benefits--Living benefits refer to amounts received before the insured's death (e.g., dividends, cash withdrawals, policy loans).
- Death benefits--Death benefits refer to proceeds under the policy and received by the beneficiary(ies) after the insured's death and because of the insured's death. Qualified accelerated death benefits refer to benefits received by you (the insured) before your death and because you are terminally or chronically ill (see below for further information).

How are living benefits treated for income tax purposes?

Principal

Life insurance principal means the same as basis does for other types of assets. It is the total amount you have paid in premiums minus any non-taxable amounts that you have received (this is referred to as the net premium cost). Living proceeds you receive that are classified as principal are not subject to income tax.

Policy loans

You may borrow against your life insurance policy. Loan proceeds are generally not treated as taxable income. Loans from a modified endowment contract (MEC) are taxed differently. Generally, loans from an MEC are taxable as income to the extend the cash value of the policy exceeds your investment (premiums paid) in the contract.

Caution: *Generally the interest you pay on a policy loan is not deductible, unless an exception applies.*

Caution: *An outstanding loan is generally treated as an amount received and may result in taxable income if the policy is surrendered or sold.*

Distributions

If you receive distributions (e.g., dividends, withdrawals, surrender) from the policy, they are treated as non-taxable principal until the full amount of the principal has been recovered, and any further distributions of living benefits are treated as taxable income at ordinary rates. This is called the cost recovery rule.

There are certain exceptions to this general rule:

- Distributions from universal life policies--Disbursements received in the first 15 years (from the policy issue date) as a result of a decrease in benefits may be taxed as income first (this is called the income-out-first rule).
- Distributions from modified endowment policies--Distributions from a modified endowment contract are subject to the income-out-first rule.

How are death benefits treated for income tax purposes?

Death benefits in general

The general rule is that proceeds from a life insurance policy received by your beneficiaries when you die are excluded from income.

Interest earned on death benefits

A beneficiary, if given such an option in the policy, may choose to receive death benefits in installments. In this case, the beneficiary receives annual payments that are part principal and part interest. The part that is classified as interest is treated as ordinary income. The part that is classified as principal is not taxable under the general rule.

Also, a beneficiary may choose to leave the death benefits entirely with the insurance company, if given such an option in the policy. This is known as the interest-only option and is not commonly used today. Here, interest is earned on the benefits. The interest may be distributed to the beneficiary or it may stay with the insurance company. The interest is taxable to the beneficiary in the year in which it is earned, whether or not the beneficiary actually receives it (under the doctrine of constructive receipt). The interest is taxable income to the beneficiary at ordinary rates. When the beneficiary does receive the principal, it is not taxed under the general rule. A surviving spouse who chooses to receive interest only may not take the $1,000 interest exclusion.

Tip: *This does not apply to government life insurance policies where interest earned is tax free.*

Death benefits received under a "sold" policy

Under the transfer-for-value rule, death benefits received under a policy that has been exchanged or transferred--that is, sold--for a consideration such as money or something of value are subject to income tax at ordinary rates to the extent of the dollar value of the consideration and any premiums subsequently paid by the transferee.

Example(s): *Fred buys a $100,000 life insurance policy. For five years, Fred pays the premiums ($500 each year or $2,500). Fred sells the policy to Barney for $2,500, and Barney pays the annual premiums for six more years ($3,000). Fred dies. Barney receives the $100,000 death benefit. Barney's income, subject to income tax, is $94,500 ($100,000 - $2,500 - $3,000).*

There are some exceptions to the transfer-for-value rule:

- Transfers made to the insured
- Transfers made to a partner of the insured
- Transfers made to a partnership in which the insured is a partner
- Transfers made to a corporation in which the insured is a stockholder or officer
- Transfers in which the transferee has a basis in the policy determined by reference to the transferor's basis in the policy
- Transfers made between spouses after July 18, 1984 (or December 31, 1983, if elected)
- Certain transfers between former spouses incident to a divorce

Death benefits received by creditors

You may name a creditor as a beneficiary to use life insurance to pay off a debt. In this case, the IRS is apt to argue that the death benefits should be subject to income tax (taxable to the creditor). The IRS's position is that the death benefits are received because of indebtedness and not because of the insured's death.

Tip: *The counter-argument in this case is that the income is a recovery of basis unless it has been written off as a bad debt.*

Death benefits considered compensation or dividends

In some circumstances, the payment of death benefits may be classified as compensation; for example, when an employer-owned policy distributes benefits as pay to an employee. In this case, the death benefits may be either: (1) treated as compensation and so as taxable income to the employee decedent at ordinary rates and deductible by the employer, or (2) in the case of distribution of the benefits to a shareholder, treated as a dividend and so taxable to the employee decedent to the extent of earnings, but not deductible by the employer.

Death benefits from a policy owned by a qualified retirement plan

When death benefits are paid from a policy owned by a qualified retirement plan, a portion of the benefits equal to the cash surrender value of the policy immediately before the insured's death is treated as a distribution from the plan taxable at ordinary rates.

How are qualified accelerated death benefits treated for income tax purposes?

In general, if you receive death benefits (i.e., qualified accelerated death benefit) early because you are terminally or chronically ill, they are treated as if they were received because of your death and are not subject to income tax. The amount of the exclusion may be limited if you are chronically ill, but there is no limit on the exclusion if you are terminally ill.

Caution: *Accelerated death benefits received before 1996 don't receive this special tax treatment.*

Technical Note: *Terminal illness means that you are expected to die within 24 months.*

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

One Resource Group
13548 Zubrick Road
Roanoke, IN 46783
888-467-6755
Life_Sales@ORGCorp.com