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Tax Planning with Life Insurance

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Wealth Management is more than just investments. It encompasses a disciplined professional approach, using a broad range of services and an experienced team of advisers.

I can help you put together your specialized team of investment, tax, legal and insurance advisers and then lead the development and implementation of your integrated wealth management plan.

If you are within 10 years of retirement, let me help you understand how the retirement landscape has changed and how these changes can impact your current and future financial decisions.

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Tax Planning with Life Insurance

What is tax planning with life insurance?

Life insurance can help you achieve various goals. Tax planning with life insurance involves minimizing the tax consequences of your life insurance decisions. Tax planning vehicles involving life insurance will vary, depending on the form of insurance coverage you select. In order to make informed insurance tax planning decisions, you must understand topics such as the tax-deferred buildup of cash value, the taxation of withdrawals, proceeds, loans, and dividends, and the deductibility of premiums. In addition, your insurance tax planning should involve a general understanding of the advantages and disadvantages of straight life insurance, modified endowment contracts, personal life insurance trusts, business use of life insurance, and life insurance as a part of a plan for charitable giving.

What is the tax-deferred buildup of cash value?

The cash value increase in an insurance policy resulting from investment income on premiums paid is not taxable income as long as the policy remains in force, even if the policy terminates in a death claim. Thus, the buildup (increase) of the cash value represents tax-deferred income. For more information, see Tax-Deferred Buildup of Cash Value.

What are the general tax rules for life insurance?

For federal income tax purposes, an insurance contract cannot be considered a life insurance contract (and thus qualify for favorable tax treatment) unless it is treated as a life insurance contract under applicable state law and meets either the cash value accumulation test or the cash value corridor test. For more information, see Definition of Life Insurance for Income Tax Purposes.

The tax treatment of your life insurance policy will vary depending on the type of distribution (i.e., a lifetime distribution, or death proceeds, or dividends). Generally speaking, lifetime distributions (other than loans) from such cash value life insurance policies are treated as made on a first in/first out (FIFO) basis for federal income tax purposes. In other words, money that you take out is treated as your nontaxable basis or investment in the contract first. Only amounts that exceed your basis are treated as taxable distributions.

Distributions

A lifetime distribution is any payment of the cash value of a life insurance policy during the lifetime of the insured, as opposed to the payment of the proceeds following the death of the insured. Generally, there are three major types of lifetime distributions: loans, partial surrenders, and full surrenders.

- With a loan, the policyowner borrows money from the insurance company, using the cash value of his or her policy as collateral to secure the loan. The amount of the loan balance reduces both the cash surrender value of the policy and the death proceeds until the loan is repaid. Policy loans generally do not generate immediate income tax liability for the policyowner because they are not treated as distributions for tax purposes. The loan proceeds are not included in taxable income as long as your policy remains in force. However, if your policy lapses or you surrender the policy, you will be required to include the outstanding loan proceeds in gross income to the extent that the proceeds exceed your investment in the policy.

Example(s): Assume you have a life insurance policy as follows: cash value equals $15,000, owner's basis equals $14,000, and unrealized gain equals $1,000. If you borrow $15,000 from your life insurance policy, your unrealized gain of $1,000 will not be taxable at present. At your death, your insurance company will subtract any outstanding loan balance (plus interest) from the death proceeds and pay the remainder tax free to your beneficiary. (The issue date of the policy doesn't matter for loans.)

- In many cases, you may choose simply to withdraw and keep all or part of the cash value buildup in your policy. This is known as a partial surrender, which reduces the cash surrender value of the policy and the death benefit amounts. Generally, a partial surrender is taxed on a first in/first out (FIFO) basis. Thus, only amounts received in excess of your basis will be treated as taxable income. (For more information, see Taxation of Benefits.)

- A full surrender occurs when you discontinue your policy. Typically, the insurance company sends you a check for the net cash surrender value at such a time. In terms of taxation, the excess of the cash surrender value of the policy (plus any outstanding loans) over your basis in the contract is treated as taxable income.

Death proceeds

Generally, amounts you receive under a life insurance contract paid by reason of the death of the insured are not included in your gross income; such proceeds are received tax-free. Amounts payable on the death of the insured are excluded, whether these amounts represent return of premiums paid, the increased value of the policy due to investments, or the death benefit feature. It is immaterial whether the life insurance proceeds are received in a lump-sum or otherwise. (However, any interest paid along with the life insurance proceeds is generally taxable.)

Tip: It's also important to be aware of the estate and gift tax aspects of life insurance. In general, the proceeds of a policy are included in the estate of the insured if:

- The proceeds were payable to or for the benefit of the estate of the insured; or

- The policy was transferred by the decedent for less than fair consideration (value) within three years before his or her death; or

- The insured held any incidents of ownership at the time of death, such as the right to change the beneficiary.

If you make a gift of your interest in a life insurance policy, the fair market value of your interest in the policy at the time of the gift may be subject to the gift tax. For more information, see Estate, Gift, and GSTT Tax and Life Insurance.

Dividends

An insurance dividend is the amount of your premium that is paid back to you if your insurance company achieves a lower mortality cost on policyholders than it expected. Dividends on a life insurance policy are generally treated as a return of investment and are not treated as taxable income to the policyowner unless they exceed the amount of the aggregate gross premiums paid on the policy. It doesn't matter whether the dividends are received in cash or left with the insurance company to prepay premiums or to accumulate. If you leave these dividends on deposit with your insurance company and they earn interest, however, the interest you receive should be included as taxable interest income.

The premiums you pay for life insurance coverage are generally not deductible. For more information on all of the above, see Taxation and Life Insurance.

What about modified endowment contracts?

A modified endowment contract (MEC) is a special class of life insurance contract defined under the Internal Revenue Code (IRC). The IRC applies special tax rules to MECs. Generally speaking, loans and partial surrenders from MECs result in immediate taxation to the extent that the cash value of the contract exceeds the premiums paid. In addition, withdrawals and borrowings from a MEC before age 59½ may be subject to a 10 percent penalty. For more information, see Modified Endowment Contracts (MECs).

What about personal life insurance trusts?

Sometimes it makes sense to either transfer an existing insurance policy on your life into a trust or to have a trust purchase a new insurance policy on your life. There are two types of trusts that can be used: an irrevocable life insurance trust (one that cannot be changed or revoked) or a revocable life insurance trust (one that can be changed or revoked). The tax treatment of these two types of trusts differs.

Irrevocable life insurance trust

The main benefit to this type of trust is that after you die, the proceeds of the life insurance policy will not be included in your estate for estate tax purposes. Therefore, this type of trust is often used if your assets will exceed the your applicable exclusion amount at the time of your death, or if you want to control the timing of a beneficiary's receipt of money. Another advantage to this trust is that if your trust beneficiaries are given "Crummey powers," your lifetime transfers of cash into the trust (to purchase a life insurance policy) may qualify for the annual exclusion from the gift tax.

Revocable life insurance trust

Assets in a revocable life insurance trust must be included in your taxable estate when you die. This could create adverse estate tax consequences. Nevertheless, this type of trust can be useful if your beneficiaries are minor children and you want to control the timing of the receipt of the insurance proceeds.

For more information, see Use of Personal Life Insurance Trusts.

Regarding business insurance, what are some of the planning vehicles?

Businesses often use several different types of insurance policies, and the tax treatment will vary depending on the type of policy. Life insurance in the form of group insurance, key employee coverage, split dollar, or corporate-owned policies can be used as an employee benefit and/or to accomplish certain business-related goals. In addition, property, casualty, and liability insurance policies are used to guard against disasters and lawsuits. Furthermore, insurance can be used to fund retirement plans and buy-sell agreements. If you are a business owner, then you may be concerned both with the deductibility of premiums and the taxation of proceeds.

In general, no deduction is allowed for premiums paid by a business on any life insurance policy covering the life of any officer or employee of the employer, or of any person financially interested in any trade or business carried on by the employer, when the employer is directly or indirectly a beneficiary under the policy. Typically, therefore, a business cannot deduct premiums paid on insurance policies used to fund buy-sell agreements and retirement plans. Also, premiums paid by a business on key employee coverage and split dollar life policies are also generally not deductible. However, a business can generally deduct the cost of group life coverage that it provides to its employees, as well as the cost of property, casualty, and liability insurance.

Despite the general lack of a deduction for premiums paid, life insurance can be a valuable tool for many businesses. Life insurance proceeds can usually be received tax-free. In addition, the cash value buildup on a life insurance policy is generally not taxed currently, although this buildup could cause the business to be subject to the alternative minimum tax (AMT) in certain circumstances. And the treatment of withdrawals and loans is often favorable.

In general, a business's withdrawals of cash value under a life insurance policy are treated as a taxable distribution of earnings on the contract first. Withdrawals that exceed the business's earnings on the contract will be treated as a nontaxable recovery of basis in the contract. Loans, on the other hand, are not treated as distributions. Therefore, they are not subject to immediate taxation. In some cases, interest on policy loans may be deductible.

The deduction for casualty losses is treated differently for business purposes than for individual purposes. For tax purposes, a casualty means a loss of property that results from a fire, storm, shipwreck, or other sudden catastrophe that causes direct damage. To the extent that the money or property a business receives as reimbursement for a casualty loss is less than the adjusted basis of the property that was damaged, the business can deduct the full amount of the difference. However, no loss deduction will be allowed to the extent that such losses are covered by insurance coverage if the business decides not to file a claim. For more information, see Special Tax Considerations for the Business Use of Insurance.

How can tax planning with life insurance help you with charitable giving?

You may have a great desire to benefit a favorite charity or charities. At the same time, you may be concerned about having sufficient assets remaining for your family members or other loved ones. Using life insurance as part of your charitable giving strategy may allow you to accomplish both of the above goals and provide tax benefits to you as well.

Naming the charity as beneficiary

If you name a charity as the beneficiary of your life insurance policy, the proceeds will not be part of your taxable estate. Your estate will be entitled to an estate tax charitable deduction, but you will not be entitled to an income tax deduction. This strategy is appropriate if you want to maintain access to the policy's cash surrender value during your lifetime but want to leave the death benefit proceeds to charity.

Transferring policy ownership to charity

You can also transfer ownership of your life insurance policy to a charity or pay the premiums on life insurance policies owned by a charity. You may qualify for a limited income tax deduction if you meet the necessary qualifications. An outright gift of a life insurance policy to charity is sheltered from gift tax by the gift tax charitable deduction.

Gift of cash surrender value

You cannot claim a gift tax charitable deduction if you assign only the cash surrender value of the policy to a charity and retain the rights to designate the beneficiary and assign the balance of the policy.

> **Tip:** You can also use life insurance in conjunction with charitable remainder trusts.

For more information on all of the above, see Life Insurance and Charitable Giving.

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