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Tax-Free Life Insurance Can Be Taxed

-John P. Napolitano, CFP®, CPA, PFS, MST, RLP®

When life insurance is sold, most agents talk about the income-tax-free nature of the death benefit proceeds. There are, however, a few exceptions.

One of the more confusing aspects of the taxation issue for insurance occurs when a policy has had cash value loans paid out to the owners. Tax rules allow for the borrowing of cash values from life policies on a tax-free basis. The problem can later occur when and if the policy lapses. The policy can lapse because you simply do not want the coverage anymore or because you borrowed so much that the contract needs more premium payments to keep it alive than you can afford.

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In this case, on the lapse of the contract, you will be taxed on the total of all cash pulled out of the contract that are in excess of your cost. Many taxpayers in this situation are stunned when the insurer sends a 1099 after the year's end.

This problem is often accelerated on a policy that may have been bought 10 to 20 years ago. If you remember when you bought the policy, the agent showed you an illustration with an assumed interest rate that is far higher than the actual rates being paid today. The lower rate on your policy's cash buildup and your borrowing of cash from the policy is putting pressure on the longevity of the contract. At some point, if you do not pay in a large deposit to get the policy solvent to make up for the lower interest rate, the policy will lapse, and you may be taxed on any gain. Typically, you will not know if your policy is on this track unless you do an analysis of policy.

If you never do this analysis, and your contract is on a bad course, you'll get a scary letter from the insurer alerting you to the need of a large deposit.

Perhaps the most significant tax issue for large life policies is the death tax. While there is currently no federal death tax, that won't last forever. In addition, today there are death taxes in most states, even for modest estates.

The way to avoid death taxes on your life insurance would be to transfer ownership of the policy to an irrevocable trust or to someone other than your spouse. Unfortunately, this won't work unless you live at least three years following the date of the transfer. That's why it is best to get these policies out of your control ASAP. Of course, the scary part once you transfer the ownership, you have absolutely no control of anything, and you are still the one expected to pay the premiums. This advice is even tougher to swallow when there is a substantial cash value in the policy.

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