LIFE INSURANCE TAXATION

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What is Life Insurance? Life insurance is a legal contract called an insurance *policy* entered into between the policy *owner* and a life insurance *company*. The policy requires the *owner* to pay premiums to the *company*, usually over a period of years on a monthly, quarterly, or annual basis. In return the *company* promises to the policy *owner* that it will pay a sum of money to the policy *beneficiary* upon the death of the *insured*.

Policy ***owner*** pays money to the Insurance company under the policy →	Insurance ***company*** pays policy amount upon the death of the ***insured*** →	***Beneficiary*** receives money on the death of the insured

How are the premiums determined? The *company* makes an actuarial determination based upon the life expectancy of the *insured* to determine how much in premiums it must collect over the lifetime of the *insured* to be able to pay the policy amount on the death of the insured. There are over 1,000 companies selling insurance and there are variations in how different companies compute their premiums. As a result, it pays to shop around to see which companies have the lowest premium rates and other features that might be best suitable for your situation.

What is the difference between whole life and term life policies? *Whole life* policies generally pay a modest dividend and build up what is called a cash surrender value so that before the death of the insured the policy will have a value that you can cash in and withdraw. With whole life policies you can often apply the dividend to either reduce the premium payment or buy additional insurance. A whole life policy is somewhat like a low interest rate savings account because of the build up in value and the payment of dividends. Also, you can generally borrow against the cash surrender value at a low interest rate if you need money. On a whole life policy, you may be able to stop paying premiums *before the death* of the insured, depending upon how the policy is set up. For example, you could have a policy that you pay on for 5 or 10 years only and it would then pay off at the death of the insured.

Term life policies do not build up cash value so if you stop paying you don't get any money back. Since there is no cash surrender value build up, the premium rates on term insurance are generally lower, especially for younger people, but as you get older, into your 60's and 70's term insurance usually gets very expensive. For term life, if you stop paying before the death of the insured there is no death benefit paid. With so many companies selling life insurance policies, there are many different features and variations on whole life and term life policies as the various companies try to distinguish themselves in the marketplace.

Life insurance value increase is not subject to income tax. Payment of premiums into a life insurance policy is similar to putting money into a savings account. The difference is that the interest earned on a savings account is taxed by the federal and state taxing authorities on your personal income tax return at the approximate rate of 38%. (Federal rate of 28% plus California rate of 10%). Thus if the savings account pays 6% interest, the after tax yield is 3.72% (6% times 62%). Money paid for premiums on a life insurance policy causes the policy to build up in cash surrender value but there is not any income tax on the value increase, nor is there any income tax on any dividends paid on the policy, so long as the dividends do not exceed the premiums paid in. Because of the value buildup and dividends being non-taxable, life insurance is often a better investment than putting your money into a savings account. Comparison computations can be made between specific life insurance policy quotes and investment into a savings account.

Are life insurance proceeds subject to the federal estate tax? If the insurance policy is owned by the insured, or if the insured is the beneficiary of the policy, then the policy proceeds are counted as part of the insured's taxable estate on the insured's death. Thus, if a person who has a million dollar net worth buys and owns life insurance insuring his life for $1,000,000, then his taxable estate becomes $2,000,000 on his death. The estate tax on the $1,000,000 life insurance policy is then about $450,000 (approx. 45%). On the other hand, if the same life insurance policy is owned by an irrevocable life insurance trust that benefits the insured children, then the children will receive the $1,000,000 life insurance proceeds free of the estate tax and free of any income tax. This tax savings can work also if the insured's children own the policy outright. One key factor to save the estate tax is that the ***insured must not be the owner of the policy.*** Either way, unless the trust is properly established and maintained, and unless the payment of the premiums are handled in the proper way, the tax savings can be lost and the life insurance proceeds will be drawn back into the insured's taxable estate. For example, it doesn't work for the insured to keep making the premium payments directly each year out of his own checkbook. As with any serious financial investment, *proper administration* and the filing of the proper tax returns for any trust involved over the course of the insured's life *is essential* to maintain the tax benefits.

Are life insurance premiums tax deductible? Generally they are not but with some types of policies, such as "split dollar", some of the premiums can be deductible. Also, a corporation can purchase a limited amount of term life insurance for its employees and get a tax deduction for the premiums.

Why would I want to consult an estate planning lawyer before committing to life insurance? Life insurance is generally a significant lifetime investment. The lawyer, in addition to the insurance agent, may be able to help you shop and compare life policies to find you the best price and features to suit your estate and tax planning needs. The premium amount differences between different policies can often amount to very large sums of money. If you are trying to save estate taxes or accomplish other estate planning objectives, the lawyer can advise as to *who* should be the policy owner, *who* should be the beneficiaries, *who* and what bank account should be used to make the premium payments, and whether a trust needs to be used. If the policy is not set up according to existing estate and income tax laws, the tax objectives won't be accomplished and the proceeds could end up being taxable in the insured's estate.

Tips from my experience.

- Term insurance is OK for younger people who need the death benefit protection for their families and want lower premium payments.
- Sufficient insurance can provide tax free money and liquidity to pay for estate taxes, college education and other essential lifetime expenditures in the event of an untimely death.
- The older you get, it is more likely that health problems may arise that will prevent you from being insured or will put you into a higher cost bracket because people with poorer health are charged higher premiums as their actuarial life expectancy is shorter.
- Whole life insurance for young children is very cheap, about $600 per year for a $100,000 policy for a 1 year old, $700 for a 5 year old, so the time to begin building your children's life insurance estate is from the beginning.
- With normal value increase, if you apply the dividends in a whole life policy to the purchase of additional insurance, after 10 to 12 years the policy will generate enough dividends to pay the premiums so the policy continues without any out of pocket cost to you.
- Even elderly people not previously insured can benefit from life insurance by using their money to buy life insurance, which if done properly through a life insurance trust or other methods, will decrease their estate and hence their estate tax, and provide their heirs with tax free money.
- A small investment by parents or grandparents in life insurance for children or grandchildren can pay enormous benefits over the lifetimes of the children or grandchildren. The power of money building up tax free in insurance policies over a generation is quite remarkable.
- Life insurance is a good way to force yourself to put away money for the future as most of us have difficulty in saving on a regular basis.