Making the Most of Life Insurance Tax Benefits

Presented by C.J. Ferrari and Mark Miller

The primary purpose of life insurance is to provide financial security for families and businesses. But did you know that it also offers a number of tax advantages?

An income tax-free death benefit

Generally, your beneficiaries won't have to pay income tax on the death benefits they receive from your life insurance policy.

But there is one caveat: If the policy transferred from one owner to another, it can trigger the transfer-for-value rule, which could negate the policy's tax-exempt status. This usually happens when a policy is transferred between stockholders to fund a buy-sell agreement. There are five exceptions to the transfer-for-value rule, though, that allow you to retain the tax-free death benefit:

1. Transfer to the insured on the policy
2. Transfer to the partner of the insured (but not to a co-stockholder)
3. Transfer to a partnership in which the insured is a partner
4. Transfer to a corporation in which the insured is a stockholder or officer
5. Transfer in which the recipient's basis is determined by the transferor's basis (e.g., a gift)

Although life insurance is generally income tax free, it is not necessarily *estate tax free*. The taxable value of life insurance in your estate is based on the death benefit. If you transfer life insurance to an irrevocable trust or to another person, it will not be included in your taxable estate once three years have elapsed since the transfer. That transfer of life insurance may trigger gift taxes, however.

Tax-deferred growth of policy cash values

As interest and dividends are added to the cash value of your life insurance policy, the amounts are generally not subject to taxes until you surrender the policy.

Some types of life insurance, such as *whole life* policies, pay dividends to the policyowner. These are not dividends in the usual investment sense; instead, they are considered a return of a portion of your annual premium.

- Dividends from whole life insurance can be used to reduce premiums or to buy additional insurance, neither of which triggers taxes.
- Dividends taken as cash are not taxable unless the amount of the dividend exceeds the premiums paid.
- Dividends reinvested to "accumulate at interest," on the other hand, are an exception to the tax-deferred growth rule, and the interest earned on these dividends is taxable each year.

Unlike whole life insurance, *universal life* policies do not produce dividends. Instead, interest is applied to the cash values without an immediate income tax impact.

In addition, you can change the type of life insurance product, or your insurance carrier, without triggering a taxable gain. A Section 1035 exchange permits the policyowner to transfer the cash value of an existing policy to a newly issued policy. You can also transfer life insurance cash values to an annuity tax free.

Tax-advantaged withdrawals from policy cash values
Another benefit of life insurance is that it allows you to withdraw your tax basis from your policy before recognizing any gain. This is often called FIFO tax treatment, or "first in, first out." A gain is defined as the amount by which the cash value exceeds the premiums paid into the policy. Premiums for some riders do not qualify as basis, and dividends received in cash generally reduce your basis.

Policy loans. You can also access your cash values through policy loans, which offer several potential advantages:

- You do not have to qualify financially for a policy loan.
- You can elect to defer interest and principal repayments.
- If you die before repaying the loan, it is repaid from your death benefit.

Although policy loans are an attractive benefit, you should not take one without careful planning. If there are outstanding loans at the death of the insured, cash values and death benefits will be reduced. When you take a policy loan, you are borrowing from the insurance company's general fund and putting up your policy's cash value as collateral. If you elect to defer your loan interest, it will be added to the next year's loan principal. If unwatched, your loan may exceed the policy's maximum collateral limit. At that time, if you choose not to make a repayment, the insurance company will recover the amount due from your cash values, potentially resulting in termination of your life insurance. At the lapse of your policy, all taxes on the deferred policy gain are due.

If you plan to use your policy cash values to supplement your retirement, be sure you understand the loan management options your policy offers. To help manage policy lapses caused by loans, some companies offer a feature known as "overloan protection."

Making the most of life insurance tax benefits
Of course, there are limits to the amount you can invest in life insurance policies. To discourage abuse of life insurance as a tax shelter, Congress has enacted certain premium limits. The premium limits differ with each type of policy, the amount of the death benefit, and the policy features. An insurance professional can discuss these limits with you and help ensure that you reap the maximum tax benefits from your life insurance policy.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

###

CJ Ferrari and Mark Miller are financial advisor located at Miller Ferrari Wealth Management, 400 SW Bluff Dr., Suite 107, Bend, OR 97702. They offer securities and advisory services as Investment Adviser Representatives of Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser. They can be reached at 541-639-8055 or cj@millerferrari.com or mark@millerferrari.com.

© 2016 Commonwealth Financial Network®