Navy Mutual

Life Insurance and Taxes

Nothing is certain except death and taxes – except when it comes to life insurance. In that case, taxes may be a little more complicated. For the majority of policy beneficiaries, a life insurance policy's death benefit is tax-free and does not have to be reported as income. However, there are always tax planning considerations and exceptions to the rule.

Exception #1: Installment Payouts

If the insurer issues the payout of the death benefit to the beneficiary in annuity installments, any interest earned by the annuity is subject to income tax during the month that it is paid out. Note that taxes are only due on the *interest*; the portion of the payment amount that is from the original lump-sum death benefit is tax-free.

Exception #2: Cash Value

Permanent life insurance policies have cash value components, and this cash value can typically be accessed through withdrawals and loans. When the cash value is stored within the policy, its value grows tax-deferred – you do not pay taxes on accrued interest. However, once you make a withdrawal, you become liable for taxes on the portion of the withdrawal that came from interest earned on the policy.

> **Note:** Policy loans are not taxable as long as the policy remains active.

You may also be required to pay taxes if you surrender the life insurance policy or if you take out a loan and the policy terminates before the loan is repaid. In both cases, you would be taxed on the amount of interest gained, not on the amount that you paid into the policy in premiums.

Exception #3: Estate Tax

If you pass away while *owning* or having owned a life insurance policy within three years of the date of death, the death benefit of the policy is counted when the IRS calculates the value of your estate. If your estate's total value is greater than $12.92 million (as an individual) or $25.84 million (for filing status married filing jointly), your heirs will owe a federal estate tax on any assets over the IRS limit. States may have lower exemption levels for their state estate tax calculations. While it may be includable in your gross estate value, the death benefit is still distributed to beneficiaries tax-free upon the death of the insured.

You can designate your estate as the beneficiary of your life insurance policy and provide directions in your [Last Will and Testament] that the death benefit be used to pay estate taxes. Or, if you have other assets from which your estate tax could be paid and would prefer that your policy's death benefit go to individuals, you can designate those individuals as your beneficiaries, and they will receive the death benefit as they would normally – tax-free. However, the policy's value is still considered when calculating estate taxes.

If you wish to avoid the estate tax altogether, the owner of the life insurance policy must be an irrevocable life insurance trust that was established and funded more than three years prior to the date of death. Putting the policy in trust allows the death benefit to pass to beneficiaries tax-free and outside your estate.

Exception #4: The Goodman Triangle

A life insurance policy may involve multiple entities. In some cases, while trying to avoid an estate tax, it is possible to trigger a gift tax upon the death of the insured instead. This is because the IRS may consider the death benefit of the life insurance policy a "gift" from the policy owner to the beneficiary.

For example, consider a life insurance policy in which the policy owner is an adult child, the insured is the father, and the beneficiaries are the adult child and his two siblings. While the father is alive, the adult child has the ability to change the policy's beneficiary solely to himself, and therefore, the "gift" to his siblings is incomplete. At the moment of his father's death, however, he can no longer change the policy's beneficiaries, and the "gift" of one-third of the death benefit to each of his siblings is complete. Each sibling is then responsible for paying taxes on their third of the death benefit to the extent that it exceeds the IRS gift tax exclusion amount.

The annual IRS gift exclusion is quite low – only $17,000 (for an individual) or $34,000 (for a couple) in 2023 – meaning that any portion of the death benefit beyond those amounts may be taxable.

Unintentional triggering of the gift tax can normally be avoided by limiting participation in a life insurance policy to two people (having either the policy owner and the insured be the same person or the policy owner and the beneficiary be the same person).

Other Life Insurance Considerations

What is a 1035 exchange?

A 1035 exchange is a transfer of funds from a current life insurance policy or annuity to a new policy or annuity *without requiring the payment of taxes*. A life insurance contract can be rolled

into a new life insurance contract or an annuity. An annuity can only be rolled into a new annuity — it cannot be rolled into a life insurance contract.

To complete a 1035 exchange, both of the following are needed from the surrendering policy:

- The cost basis, or documentation showing funds paid in and earned by the plan, minus any fees or loans
- A check in the amount of the plan balance after all deductions

The policy owner and insured or annuitant must be the same between the old policy and the new policy. Multiple life insurance contracts can be rolled into one, so long as the policy owner and insured are the same between all contracts.

What is a modified endowment contact?

A modified endowment contract (MEC) is a permanent life insurance policy that was funded with more premium contributions than would otherwise be necessary to fully fund the same policy's death benefit over seven years – known as the "Seven-Pay Test." Once the sum of all premium contributions exceeds the IRS limits, the contract no longer receives all of the tax advantages afforded to life insurance policies.

How is a MEC taxed?

Any interest earnings contained within a MEC are disbursed first in the event that a withdrawal, loan, or dividend distribution of cash value occurs during the lifetime of the insured. In addition to last-in-first-out tax treatment, any taxable gain distributed from the cash value of a MEC is also subject to a 10% IRS imposed penalty if the distributions occur prior to the owner being 59 ½ years of age.

Note that MEC tax treatment does not impact tax-deferred cash value accumulation within the contract or the tax-free nature of a death benefit settlement.

> Life insurance and taxes may seem overwhelming, but the rules are relatively simple when you dig in. If you have any questions about your policy, our representatives can get you the answers you need. You can reach us at 800-628-6011.