Life insurance

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Allianz Life Insurance Company of North America

Life insurance: an overview of the tax benefits and laws

While it's important to understand the reasons to own life insurance, it is also critical to understand the tax benefits and tax laws associated with life insurance. The following information is provided as an overview. Please contact your financial professional or tax attorney for guidance regarding your unique situation.

Every life insurance policy serves the same purpose: to provide financial security to surviving beneficiaries through a death benefit when you die. A key benefit of life insurance is that the death benefit is paid to the beneficiary, generally income-tax-free. In addition to providing a death benefit, many permanent life insurance policies, such as fixed index universal life (FIUL), build cash value – living benefits that can potentially generate tax-deferred income to help meet your unique financial needs.

How the IRS defines a policy

There are many different types of life insurance. But to qualify for favorable tax treatment, the contract must satisfy the Internal Revenue Code (IRC) definitions of what is or is not a life insurance policy. Under IRC Section 7702, life insurance contracts have to pass one of two tests: the cash value accumulation test (CVAT) or the guideline premium test (GPT). Life insurance companies and their actuaries make sure that the life insurance policies they sell meet these definitions.

Premium payments

Because life insurance is considered a personal expense, the premiums you pay for life insurance coverage are generally not tax-deductible (see IRC Section 262(a) and 264, and Treasury Regulations Section 1.262-1(b)(1)).

Income-tax-free death benefit

Under the general federal tax rules as provided in IRC Section 101(a)(1), death benefit proceeds are paid to the beneficiary income-tax-free.[1]

Death benefits paid out before the insured's death due to chronic or terminal illness of the insured are generally income-tax-free; however, there are exceptions. For chronic illness certain limits may apply.

If you are the owner of and the insured on a life insurance policy at the time of your death, the proceeds from that insurance policy will be included in your taxable estate. The unlimited marital deduction or the federal estate tax exemption in effect at your death could possibly reduce or eliminate federal estate taxes.

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This piece must be accompanied by the "Understanding fixed index universal life insurance" brochure (M-3959) or the appropriate fixed index universal life insurance consumer brochure.

[1] There are a few exceptions to that rule when a death benefit could be taxable, such as if a policy is business-owned and the special notice and consent rules on those policies are not met, or if the policy was transferred for value (IRC Section 101(j) and 101(a)(2)).

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The policy would not be included in your taxable estate if someone other than you (e.g., an adult child or a trust) is the owner – and the beneficiary of the policy is not your estate. See IRC Section 2042 for more details.

Note: If the owner, the insured, and the beneficiary are three different people, the payment of death benefit proceeds from a life insurance policy to the beneficiary may result in an unintended taxable gift from the owner to the beneficiary. Your tax attorney can provide guidance if this situation applies to you.

Tax-deferred growth

Most permanent life insurance policies provide cash value accumulation potential, which accumulates tax-deferred over time. To qualify for tax deferral the cash value accumulation must meet the definitions in IRC Section 7702 (Revenue Ruling 66-120; Cohen v. Commissioner, 39 TC 1055 (1963) acq. 1964-1CB4). Ask your financial professional or tax attorney to review your policy if tax-deferred growth is an important part of your overall financial strategy.

Tax-advantaged distributions

Loans from a life insurance policy that is not a modified endowment contract (MEC) are not taxable since they are not considered a distribution under IRC Section 72(e)(5). However, if the policy is completely surrendered with outstanding loans on it, the borrowed amount is taxable to the extent the outstanding loans exceed the owner's basis in the policy (Atwood v. Commissioner TC memo 1999-61).

Cash withdrawals from a life insurance policy that is not a MEC are tax-free up to your basis amount and are treated as a nontaxable return of premiums paid. Any withdrawals reduce policy values, including your death benefit. Withdrawals in excess of your basis (gain) may be taxed as ordinary income (IRC Section 72(e)(5)(C)). This tax rule of basis out first is sometimes referred to as the FIFO rule – first in, first out, for policies that are not MECs. Special rules apply to withdrawals during the first 15 years of the policy.

If you surrender your cash value life insurance policy that is not a MEC, your basis will not be taxed. However, any gains on the policy will be subject to income tax.

If your policy is classified as a MEC (a situation that generally occurs when you put in more premiums than allowed), then the gain must be withdrawn first and is considered taxable income. That rule also applies to loans from a MEC policy. In addition, if the owner of the MEC policy is under age 59½, an additional 10% federal tax applies to the taxable gains unless another exception applies. The tax rule of taxable gain out first for policies that are MECs is sometimes referred to as the LIFO rule – last in, first out. These rules also apply to a surrender of MEC. For more information about MECs, see IRC Section 7702A.

1035 exchanges

Your needs and financial objectives may change over time and present a necessity to reevaluate your insurance products. If exchange requirements are met, IRC Section 1035 generally allows for you to exchange certain life insurance products for new products which may better suit your changing circumstances and avoid tax consequences. Reference "Understanding the 1035 Exchange" (AMK-238-N) for additional information.

Contact your tax advisor or financial professional for more information.

Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

This information is being provided only as a general source of information and is not intended to be the primary basis for investment decisions. It should not be construed as advice designed to meet the particular needs of an individual situation. Please seek the guidance of a financial professional regarding your particular financial concerns. Consult with your tax advisor or attorney regarding specific tax issues.

Guarantees are backed by the financial strength and claims-paying ability of Allianz Life Insurance Company of North America.

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