

OAKLAND BUSINESS & Finance

Grasp details of life insurance taxability

MORE THAN MONEY

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Ph.D.

One of the most overrated and misinterpreted statements in the life insurance industry is that life insurance proceeds are tax free.

This statement is not only misleading but, in certain instances, could be devastating. A summary of the rules governing the taxability of life insurance proceeds is presented in the accompanying table. Clearly, the tax consequences significantly differ between distribution after death and during lifetime.

The table reveals that all life insurance policy death benefit distributions are exempt from federal income tax and, with few exceptions, from state inheritance taxes. In addition, whether a policy's death benefit is subject to federal estate taxes depends on who owns the policy. This point requires a short explanation.

It may not be generally recognized that the insured does not have to be the owner of the policy. If the insured and the owner are the same individual, then life insurance proceeds are included in the gross estate of the insured owner.

However, if someone other than the insured, such as a life insurance trust or an irrevocable trust, owns the policy, the proceeds will not be included in the gross estate of the insured, and the life insurance proceeds will pass on to the beneficiaries free of estate taxes. It should be understood, however, that once the ownership of a life insurance policy is transferred to an irrevocable trust, the insured cannot change the terms of the insurance contract.

Distribution during life

Policy loan — The law permits the tax-deferred accumulation of interest as long as the growth

Taxability of Life Insurance Proceeds

Type of insurance	Policy owner	Upon Death				During Life	
		Federal income tax	State inheritance tax ¹	Estate tax	Loan Income tax	Annuity distribution Income tax	Total surrender Income tax
Term	Insured	None	Yes	Yes			
	Other than insured	None	None	None			
	Irrevocable life insurance trust	None	None	None			
Cash value	Insured	None	Yes	Yes	Taxed ²	Tax on gain	On excess of cash over premium
	Other than insured	None	None	None	Taxed ²	Tax on gain	On excess of cash over premium
	Life insurance trust	None	None	None		Tax on gain	On excess of cash over premium
Deferred annuity	Insured	Tax on gain	Yes	Yes	Only on interest	On excess of cash over premium	On excess of cash over premium
	Other than insured	Tax on gain	No	No	Only on interest	On excess of cash over premium	On excess of cash over premium
	Life insurance trust	Not applicable	No	No	Only on interest	On excess of cash over premium	On excess of cash over premium

¹ In some states, death benefits are not exempt from state inheritance tax.

² Loans are not taxed if seven-pay test is met.

Clearly, the tax consequences significantly differ between distribution after death and during lifetime.

takes place inside an insurance policy. However, if the accumulated interest is withdrawn in the form of a loan, it is taxed as ordinary income.

Annuity distribution — Both fixed and variable annuity contracts assume that periodic payments represent a combination of return of principal and distribution of interest. Consequently, when a life insurance company makes an annuity payment, the return of principal portion escapes federal income taxes. The

interest portion is taxed as ordinary income.

Total surrender — When a policy is surrendered and life insurance coverage is canceled, the cash value (surrender value) is returned to the policyholder. In this case, the difference between the

total amount of money received (cash value minus loans outstanding) and the total premium paid is taxed as ordinary income.

Sid Mittra, Ph.D., CFP, is professor of finance, Oakland University, Rochester Hills, and owner of Mittra & Associates, a Troy financial consulting firm. Oakland University Professor Jerrold Grossman critically reviewed this column.

BUSINESS MILESTONES

This column highlights promotions, transfers, hires and other key personnel moves within the Farmington-area business community. Send a brief biographical summary — including the towns of residency and employment and a black-and-white photo, if desired — to: Business Editor, Farmington Observer, 33411 Grand River, Farmington, Michigan 48335. The Observer's fax number is 1-810-477-9722.

Modern Engineering Inc.'s Board of Directors has named Larry Moore of Farmington Hills as vice president of the Ford Customer Program Center. He has a bachelor of science degree in mechanical engineering from the University of Kansas and a master's of business administration degree in marketing from Michigan State University. He is listed in the Who's Who Worldwide Registry-Platinum Edition.

Alternative Living Services has added Judith George to its staff as facility director for Hamilton House of Farmington Hills. It is one of three Alzheimer's care residences ALS owns and operates in Michigan. George is a registered nurse with 21 years of experience.

HDS Services, a Farmington Hills-based food service and hospitality management company, hired Frank Modella as regional vice president. He will oversee the western region which includes Arizona, Colorado and Nevada. He will be responsible for management development and procurement for these areas. He attended Western Michigan University where he earned his BBA.

Kenneth Roberts was appointed vice president of pulley and tensioner operations by The

Gates Rubber Company. He will be based at the company's automotive original equipment sales office in Farmington Hills. In his new position he will be responsible for overall management of pulley and tensioner business, which includes manufacturing facilities in Dothan, Alabama and Strathroy and Windsor, Ontario, Canada and one in Aschen, Germany.

Nearer D. Swannigan, Jr. of Farmington Hills was appointed plant manager for Lear Seating Corp. He received a bachelor of science degree in electrical engineering at Christian Brothers University, a master's of business administration from Florida Institute of Technology, and a Juris Doctor at Detroit College of Law.

Dean J. Gould of Farmington Hills, a partner in the law firm of Jackier, Gould, Bean, Upfal, Elzerman & Goldman, P.C., has been elected to a one-year term as president of the Jewish Vocational Service Board of Trustees. He will join other community leaders re-elected as officers of the board. He first became affiliated with JVS nearly 20 years ago as a student intern through the agency's Jewish Occupational Intern program.

He has since served on a variety of committees and held leadership positions with the organization. He is a member of the State Bar of Michigan and a graduate of the University of Michigan and Wayne State University Law School.



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