"Are life insurance proceeds taxable?"

This is a common question that comes up if you recently received a life insurance payout or are pondering cashing out your policy. There are income tax and estate tax implications that can arise at both federal and state levels if you are named a beneficiary of a life insurance policy with or without your knowledge.

Generally speaking, for income tax purposes, life insurance proceeds are ***not*** taxable to the beneficiary if you received the payout due to the policyholder's death. There are some exceptions to this rule but the proceeds are typically not considered to be taxable income. The cash value of life insurance policies may also factor into estate tax configurations. Here are some common situations where life insurance proceeds could create tax impacts.

Interest on Delayed or Periodic Death Benefits

For many policyholders, death benefits are received immediately and subsequently there are no impacts on the beneficiaries' income taxes. However, some policyholders opt to have the proceeds held for a prescribed period such as six months or a year to minimize conflict in the estate administration process. This can produce a significant amount of taxable interest which would be reported to the beneficiary on a 1099-INT.

Taxable interest may also be generated if the life insurance proceeds are paid to the beneficiary periodically in installments opposed to one lump sum payment immediately after the policyholder's death.

Interest is also considered investment income for purposes of the Net Investment Income Tax and the earned income tax credit, which can create additional tax impacts. Regardless of the amount of the payment, it is only the interest and not the base amount of the proceeds that gets taxed.

Early Surrender of Whole Life Insurance

If a policyholder cancels a term life insurance contract, it doesn't have tax consequences due to lacking cash surrender value. But if a permanent (whole) policy is canceled prior to the policyholder's death, they receive the entire cash surrender value back.

Similar to capital gain calculations, the policyholder is taxed on the additional income portion of the payout but not the premiums they paid in. For instance, if $10,000 in premiums were paid over the years that the policy was in effect and it resulted in $30,000 in proceeds, then $30,000 will be reported on a 1099-R form with the $20,000 taxable portion shown separately.

Accelerated Death Benefits and Terminal or Chronic Illness

Accelerated death benefits, also called viatical settlements, can be arranged with the insurance company if you are chronically or terminally ill and need to access your benefits now. These settlements do not create taxable income so if you need to terminate your policy due to illness, this arrangement should be made.

If you terminate your policy for any other reason, such as financial hardship or startup funds for a business, then the income in excess of premiums paid is taxed as an ordinary early surrender.

Life Insurance and the Estate Tax

Separate of income tax issues, there may be additional impacts at the estate tax level when life insurance proceeds come into question.

If no beneficiary was defined or the primary beneficiary predeceased the policyholder with no contingent beneficiaries named, the life insurance proceeds will be allocated to the policyholder's estate. A federal estate tax return is required if the gross estate is worth more than $11,180,000 if the policyholder died in 2018. Not all states have their own estate tax but of the ones that do, the minimum filing threshold could be significantly lower so life insurance proceeds could necessitate paying state taxes at the estate level.

The face value of life insurance proceeds generally do not create taxable income provided that they were received as a condition of the policyholder's death but there may be taxable interest. However, if you surrender a policy for reasons other than severe illness then you can face tax consequences.