Federal tax benefits of life insurance

Listed here are a number of federal tax benefits that give a significant competitive edge to cash value life insurance versus other fixed financial assets:

- IRC Section 101(a) provides that death benefits of life insurance are generally income tax free when paid to the policy beneficiary. This is true whether the death benefit is paid to an individual, a business entity, a trust, or an estate. The death benefit can also be made estate tax free if the policy is owned by a third party (adult child) or an irrevocable trust.
- The policy can pay out tax-favored benefits to the policy owner before the death of the insured. For non-MEC policies, cash can be withdrawn from the policy tax free -- in most cases -- up to the adjusted cost basis (First in, First out- FIFO) under IRC Section 72(e)(5). Withdrawals will reduce the policy's cash value.
- The policy can pay out tax-free cash to the policy owner in the form of policy loans at a stated rate of interest. Loans will reduce the policy's cash value and may reduce the death benefit. This assumes the policy never lapses while the insured is still alive. Keep in mind that the tax free treatment of policy loans only applies if the policy is not a MEC.
- Tax-free cash value withdrawals or loans are not subject to the 3.8% passive income tax under the Affordable Care Act (ACA). Also, tax-free withdrawals or loans are not considered as income for purposes of calculating income taxes on Social Security retirement benefits. And cash value life insurance is not considered to be a countable asset on the FAFSA application for college financial aid at public colleges.
- The policy owner may receive an income tax free advance of some of the death benefit for certain long term care expanses, chronic, or terminal illness under IRC Section 7702B or IRC Section 101(g). These potential tax free benefits depend on the design of the policy which may or may not include certain long term care riders.
- Growth of policy cash values in excess of the cost basis are typically income tax deferred while they remain in the policy. However, a complete surrender of a policy in a gain position will have income taxes on the gain in excess of adjusted cost basis.
- A policy in a gain position can be exchanged tax-free directly to another insurance carrier under IRC Section 1035(a). Often, this exchange can result in an equal or greater death benefit, lower or no future premiums, or a combination of the both.
- A policy in a gain position can be exchanged tax-free to another carrier for either a deferred annuity or an immediate annuity contract under IRC Section 1035(a).