

# Taxation of Life Insurance Proceeds

## Income Taxation

Death proceeds of a life insurance policy are almost always income tax free. See IRC Sec. 101.

## Federal Estate Taxation<sup>1</sup>

Proceeds of a life insurance policy will be included in your estate in two situations:

- If your estate is named as the beneficiary, or
- If you have incidents of ownership in the policy (for example, if you have the power to change beneficiaries, borrow against the cash values, surrender the policy, etc.). See IRC Sec. 2042.

## Transfers Within Three Years Prior to Death

If you make a gift of a life insurance policy and then die within three years, the full face amount of the policy will be included in your gross estate for estate tax purposes. See IRC Sec. 2035.

## Should You Cross-Own Policies?

Prior to 1982, married couples would frequently own the life insurance policies on each other's life. This technique often kept the insurance from being taxed when the first spouse died.

Since January 1, 1982, however, federal law has provided for an unlimited marital deduction. This means that any amount of assets transferred to one's spouse are not subject to estate or gift taxation. Therefore, any life insurance policies payable to the surviving spouse (no matter which spouse owns them) will not be taxed because of the unlimited marital deduction.

## The Problem

When the surviving spouse later dies, his or her estate will have been enlarged by the insurance proceeds collected at the death of the first spouse. Now there may be a substantial tax problem.

An irrevocable life insurance trust or ownership of the policies by children or grandchildren can remove the proceeds from the insured's estate, as well as the estate of the surviving spouse.

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<sup>1</sup> Under the Tax Act of 2001, the federal estate tax is gradually phased out until its final repeal in the year 2010. If Congress does not act at that time to repeal it for the years following, it will automatically revert back to the rates in effect during the year 2001, with an exemption for the first \$1,000,000 of assets.