The Tax Advantages of Life Insurance and Annuities

By Cyril Tuohy| *InsuranceNewsNet*

Life Insurance

Life insurance can provide beneficiaries with cash to pay estate taxes. This may be a solution to liquidity problems in many estates that involve family-owned businesses, large real estate holdings and collectibles. Although life insurance proceeds pass on to beneficiaries free of income tax, the proceeds are not necessarily free of estate taxes.

Estate Tax Benefits

Insurance policies can be bought to provide heirs with income upon the policyholder's death, or the policies can be structured to help pay estate taxes due at death. If you own the policy, it will be part of your estate and subject to estate taxes unless the policy is owned by an irrevocable life insurance trust.

Second-to-Die Life Insurance Policy

Life insurance can be used to create an estate or preserve its value after estate taxes through a survivorship or second-to-die life insurance policy that defers estate tax payments until the death of the second spouse. These policies provide liquidity to pay estate taxes.

Irrevocable Life Insurance Trusts (ILITs)

Creating and funding an ILIT with annual gifts helps maximize annual gift tax exclusions and trim estate taxes. ILITs purchase a life insurance policy on your life and use your gifts to pay the premiums. The trust becomes the owner as well as the beneficiary of the life insurance policy. At your death, proceeds are paid to the trust, which can use the proceeds to purchase assets from or make a loan to your estate. Assets purchased by the trust may then be distributed to the trust beneficiaries — your heirs.

Lifetime Asset Transfers

Tax-free gifts are allowed through the annual exclusion. If the market value of the gift exceeds the amount of the exclusion, the excess reduces the amount of the applicable credit. If you use a portion of the applicable credit toward lifetime gifts, less value may be transferred federal estate tax-free at death. However, all income and appreciation of assets properly transferred during your lifetime are removed from your taxable estate.

Gifting to Individuals

Gifting assets removes future appreciation on the asset gifted, which could mean lower federal estate taxes. You may realize income tax benefits by transferring any unrealized appreciation in the gifted asset to the individual, who may be taxed at a lower rate.

You cannot transfer the unrealized loss in any asset that has decreased in value, however. In such a case, neither the donor nor the recipient can benefit from the tax loss. The donor may, however, sell such an asset, recognize the tax loss and gift the sales proceeds.

Annuities

Annuity contracts can offer tax-deferred growth. Because there is no distribution required at age 70½, the money continues to grow tax-deferred.

Annuities also give contract holders control over when to pay taxes by timing distributions, offer contract holders the opportunity to make unlimited contributions, let contract holders decide if they want guaranteed income for life and in the case of fixed-rate annuities, a fixed rate of return.

The death benefit passes on the account value to beneficiaries, which may avoid probate, but is not tax-free.

Tax-Deferred Accumulation

If owned by an individual, all earnings in an annuity are free of federal, state and local income taxes until you start receiving annual payments. Withdrawals of earnings are subject to ordinary income tax, and a penalty may apply for distributions taken before age 59½.

Accessing Annuity Income

Annuities give their owners access to their money, although insurance company surrender charges may apply.

Distributions from a deferred annuity on a non-annuitized basis consist of withdrawals of earnings first, and therefore taxable. But withdrawals exceeding earnings are considered a tax-free return of principal.

This option keeps your money growing tax-deferred while allowing you to draw income. But since the contract holder determines the amount of the distributions, the annuitant controls when and how much in taxes to incur.

But since the withdrawals are not considered annuitizing the policy, they are taxed as earnings first until all the earnings have been withdrawn.

A lump-sum distribution, however, means the contract holder bears the tax liability on earnings all in a single year and push an annuitant into a higher tax bracket.

Annuitants who choose a lifetime annuity option will receive annuity payments that are taxed according to the exclusion ratio. This means that each payment consists of a partial payment of interest, subject to ordinary income tax, and a partial payment of principal, tax-free, until the entirety of the principal has been returned.

Barring some exceptions, early withdrawals incur a tax penalty on earnings.