
Income Taxation of Life Insurance

GENERAL RULES

- **Premium payments** made by the policyowner are not deductible.
- **Death benefits** are generally received income tax free regardless of the policy beneficiary or reason for the insurance.
- **Cash values** generally grow tax-deferred.
- Upon the **surrender** of a life insurance policy, the cash value in excess of the policy's cost basis is taxable as ordinary income. (Basis = Total premiums paid – untaxed distributions including: withdrawals, loans, premiums for accidental death, waiver of premium and other riders).
- **For policies that are not Modified Endowment Contracts (MECs):**
 - Cash value **withdrawals** are income-tax free up to basis. Cash value withdrawals in excess of cost basis are taxed as ordinary income. (Cost basis = Total premiums paid – untaxed distributions including: withdrawals, loans, premiums for accidental death, waiver of premium and other riders).
 - **Cash value loan proceeds** are income tax free as long as the policy stays in force.
- **For policies that are Modified Endowment Contracts (MECs):**
 - All distributions, including both withdrawals and loans, are taxed as income to the policyowner to the extent there is a gain in the policy, (Last In First Out “LIFO” basis). Distributions are treated first as a gain (if any), then as cost basis. (Cost basis = Total premiums paid – untaxed distributions including: withdrawals, loans, premiums for accidental death, waiver of premium and other riders).
 - Distributions from a MEC may also be subject to an additional penalty tax of 10% on amounts includable in gross income if the distribution is made prior to the policyowner's attaining age 59 ½, unless the policyowner is disabled or receives the cash surrender values under a life annuity settlement option. The penalty tax is always applicable if the MEC policyowner is a “non-natural person” such as a corporation or certain trusts.
 - As required by law, taxable distributions will be reported to the Internal Revenue Service.
- **Policy loan interest payments** are generally treated as a non-deductible personal expense for a policyowner who is a natural person. Rules governing the deductibility of loan interest by businesses are exceedingly complex.