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# Taxes on life insurance: Here's when proceeds are taxable

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Life insurance: It isn't a fun topic to think about, but it's an important investment that can protect and financially take care of your loved ones after you pass.

The magic of life insurance — whether it's a term or whole life policy — is that most of the time, proceeds for beneficiaries aren't taxable. But there are certain situations where payouts will end up getting split between individuals and Uncle Sam.

## When life insurance IS NOT taxable

In these common situations, proceeds aren't subject to income tax:

### Payout to a beneficiary after someone dies

This is the most common way life insurance is used: to provide financial means to beneficiaries after a loved one dies. Although this money might seem like income, it will not be taxed by the Internal Revenue Service (IRS), according to its website.

### Value built over time but is not subject to a capital gains tax

A permanent life insurance policy can build value over time.

Here's how it works: a portion of the monthly premium is placed aside for a "cash value," and the remaining portions are put toward the actual policy and administrative costs. The company then invests the cash value, meaning it grows over the years. Although it's a growing investment, policyholders are not required to pay a tax on the earnings.

### Surrender payout is less than what you paid in

Those who no longer want a life insurance policy can "surrender" the policy, or cancel it entirely. Surrendering a policy means the insured can have the decision to take the "cash value," or the portion of the policy that is available to the policyholder upon surrendering.

**Dividends aren't taxable**

Some life insurance policies pay out dividends to policyholders on a quarterly or annual basis. The dividends can be taken as cash, used to reduce a premium, reinvested to earn more interest or to purchase more insurance. These dividends are generally not taxable by the IRS as long as they don't exceed what the policyholder paid in premiums.

**When a payout is given for a terminally ill, but still living individual**

Jennifer Correa Riera, partner of Fuerst Ittleman David & Joseph brings up a point about life insurance that isn't commonly discussed: payouts while the insured is terminally or chronically ill. Correa says these proceeds, known as terminal illness riders, are treated as an amount "paid by reason of the death of the insured," and therefore are excluded from gross income.

**When life insurance IS taxable**

For most people, life insurance proceeds won't be taxable. But for some, life insurance will be subject to taxes if it's included in an estate and is above a certain threshold.

Here are the scenarios when life insurance proceeds are taxable:

**When a payout is done in installments instead of full**

There are two options for receiving a life insurance payout: in full, or in installments.

"If the payout is paid in installments, the interest that accrues on the payouts is taxable. The death-benefit is not taxable, only the interest on installments," says Jonathan Holloway, co-founder of NoExam.com, a digital life insurance brokerage.

Installment plans may be beneficial for individuals who need the money spread out over a certain period of time, or aren't sure if they can resist spending the lump sum all at once.

**If the estate is worth more than $11.4 million**

Only spouses are exempt from getting taxed in life insurance policies. Anyone else, like a parent or sibling, will have to pull the proceeds from an estate. This means the money is subject to taxation, if the estate is large enough.

In 2019, the Federal Estate Tax Exclusion amount is $11.4 million for individuals. If someone were to pass away and have an estate valued above that amount, any amount above the threshold would be taxed at 40 percent.

"This can happen when a beneficiary is not chosen, or the beneficiary passes away before the policyholder," says Phil Murphy, vice president of insurance at Ethos. "This can be avoided by naming a contingent beneficiary in addition to your primary one."

**What should you do with life insurance proceeds?**

There aren't any limitations on what beneficiaries can do once they've received life insurance proceeds. The funds could be used for anything — including paying off a mortgage, catching up on monthly bills or preparing for future college plans.

But some folks who receive a big chunk of change after a life insurance payout might find themselves in an emotional state — and not in the best state of mind to make sound financial decisions with the money.

Thomas D. Currey, owner of TDC Financial Services in Grand Prairie, Texas, and chair of the board of directors of the nonprofit Life Happens, warns individuals to be careful with their newly acquired windfall.

"The one word of caution I'd have is that when anyone comes into a large sum of money, it's easy to spend first and ask questions later," Currey says. "Seeking counsel to help you assess what your current needs are and how to make it go as far as possible is always a good idea."