Don't Let Taxes Cut into Your Heir's Life Insurance Benefits

Having a life insurance policy is a must for anyone with a family reliant upon their income. If you were to die without a life policy to protect your family, they could very easily find themselves in an insurmountable financial crisis.

A life insurance policy works to ensure that your family's financial needs, from everyday living expenses to the future college tuition of a child, will be covered should you pass away.

A life insurance policy's death benefit can be tax-free and far exceed the premiums you've paid every year for the policy — that is if it's set up correctly. On the flipside, the death benefit could be taxed so severely that your loved ones would only receive a fraction of it if you don't ensure that ownership and beneficiary designations are properly set up.

To avoid that scenario, keep these tax elements in mind when you're structuring your life insurance policy:

Don't name your estate as a beneficiary

Everything you own at the time of your death (your assets) may be subject to the federal estate tax. This tax is paid from your estate.

The exception is if your assets are valued at a lesser amount than the amount of the federal estate tax exemption, in which case the federal estate tax usually isn't imposed. In 2023, the gift and estate tax exemption is $12.92 million ($25.84 million per married couple).

When you name yourself/your estate as the beneficiary of a life insurance policy, it will raise the value of your estate. Depending on the value of your estate and the benefit amount from the life insurance policy, combining the two may raise the total value of your estate over the federal estate tax exemption amount.

If this happens, the entire amount of the death benefit could be taxed and your beneficiaries could be left a fraction of the money.

It's much more prudent to name someone other than yourself or your estate as the owner and beneficiary if you think there's a possibility the death benefit could be affected by estate taxes.

There are several alternative options to naming yourself/your estate as the beneficiary and owner, such as either naming an adult child or an irrevocable trust as both owner and beneficiary of the life insurance policy.

Both of these options would ensure that the death benefit from your life insurance policy isn't included in your estate's value.

Name contingent beneficiaries

Financial experts recommend that you name a minimum of two contingent beneficiaries on your life insurance policies.

Let's say you only have one beneficiary named on your life insurance policy. If that beneficiary dies before you can name another, if you then pass away the death benefit would be paid directly to your estate, thereby raising the value of the estate, and possibly causing your loved ones the estate tax problems mentioned above.

On the other hand, if you have more than one beneficiary named when you die, then the death benefit will automatically go to the next beneficiary in line if the preceding one is deceased.

Don't forget about gift taxes

Always consult a tax or legal professional before transferring a life insurance policy to a third party. Gift taxes can apply to such transfers to anyone other than a spouse.

Should you fail to live at least three years following the gift, the life insurance policy will return to your estate. Again, this will increase the value of your estate and possibly subject your heirs to estate taxes.

You certainly don't want tax issues to keep your loved ones from receiving the full protection and benefit of your life insurance policy. Call us to discuss your life insurance needs and how you can ensure any life policy proceeds are not reduced by taxes.

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