THE UKRAINIAN NATIONAL ASSOCIATION FORUM

The UNA Q&A: Death and taxes

Do I have to pay "death taxes" on the proceeds of a life insurance policy?

Several times, we have written that life insurance is a "tax-advantaged" financial product. To better illustrate the tax advantages of life insurance, and to better answer this question, we will have a quick look at some of the taxes that are connected to the transfer of wealth.

In the United States, each citizen spends a good part of his or her life managing taxes. Taxes on individuals are imposed at three levels: federal, state and local. When alive, you are taxed through sales, income, payroll (FICA), property and gift taxes; when dead, applicable taxes include federal and state-level estate taxes, state-level inheritance taxes, as well as state-level probate fees. Since the second group of taxes applies to your wealth after you have died, often they are referred to collectively as "death taxes." However, each of the three elements – estate, inheritance and probate – is very different and each has different tax implications.

When it comes to life insurance, the key tax advantage actually is not related to "death taxes", at all, but to income taxes. Beneficiaries, the recipients of proceeds from a life insurance policy, do not have to pay federal or state income taxes on the proceeds they receive from a life insurance policy. For example, if your son and daughter are named as your beneficiaries on a life insurance policy worth $250,000, they will receive the full $250,000 without paying any income tax on the amount.

A second advantage to life insurance is that if the beneficiary is a person, and not a non-living entity such as a charity or your estate, then life insurance proceeds avoid probate and go directly to the heir. Probate fees are often lumped in with the term "death taxes," however, this moniker is incorrect. Technically, probate fees are not a tax, but a fee assessed by the court system of a state to make sure that an estate is settled properly, in particular if there is no will. To avoid probate, a well-written will is required, plus designated recipients on all wealth and property, such as bank accounts, annuities, CDs, insurance, real estate.

For property that does fall into probate, court fees can run from 2 percent to 10 percent of the amount in probate, so the more money that can be kept out of probate, the better for your heirs. With a properly designated beneficiary, the proceeds from life insurance are always outside of probate, therefore, they are not subject to probate fees.

Now let's take a look at the other so-called "death taxes" – estate and inheritance – and their relationship to life insurance.

Fundamentally, the estate tax is a tax on the right to transfer wealth to your heirs. The federal government, and some state governments, impose this tax. Although many people oppose the estate tax, it has been in place since the beginning of the 20th century. One argument in support of the estate tax was that the power that comes with wealth should not be passed from generation to generation, rather each generation must earn wealth and power on its own; a second argument was that having an elite moneyed class with its own separate set of interests was against the common good.

Since the estate tax is a tax on the right to give away money, the tax is imposed on the estate of the deceased, not on the beneficiary. Therefore, before heirs can receive the money due them, if an estate tax needs to be paid, the government gets the money first.

An inheritance tax is the opposite of an estate tax; it is a tax on the heirs for the right to receive wealth and taxes a percentage of the bequest. The federal government does not impose an inheritance tax, however, several states do. With both an estate tax and an inheritance tax, Maryland and New Jersey tax both the right to give and the right to receive wealth.

Unlike the simplicity of income tax and life insurance proceeds, the issue becomes trickier when considering estate and inheritance taxes. Upon death, for federal tax purposes, if an estate is valued at less than $5.25 million starting in 2013, then your estate will owe no estate taxes. Any amount over is taxed at 40 percent. Among the items included in the value of an estate are property, investments, as well as the cash value of life insurance that you own, even if your children are listed as beneficiaries. Nonetheless, only one in approximately 500 estates nationwide will exceed the high limit and be subject to the federal estate tax, so chances are good that most of our readers will not be in the position of paying federal estate taxes.

While the estate tax applies to the wealth of the deceased, the inheritance tax applies to the wealth received or inherited by the living. Although there is no inheritance tax at the federal level, six states now have an inheritance tax.

Prior to the federal tax changes of 2001 and 2003, all 50 states had estate tax laws linked with the federal estate tax system that worked in tandem. During the past decade, however, because of the major tax changes, federal and state estate laws became unlinked. States then began to design their own estate tax laws. Others then instituted inheritance tax laws. Since 2001, the result has been a bit of hodgepodge. Currently, 21 states have either state-level estate taxes and/or state-level inheritance taxes that differ from each other and from the federal laws. The remaining 29 states have no such tax laws at present.

With regard to the size of an estate subject to estate tax, most states have a much lower limit than the federal limit of $5.25 million, with some limits as low as $500,000, and with the average at about $1 million.

States with an inheritance tax charge between 5 percent and 16 percent of the value of the transferred wealth. At the state level, inheritance tax is not applied to life insurance proceeds received by those who are considered primary beneficiaries, such as parent to child or sibling to sibling. However, the laws begin to vary among states when considering second-tier heirs.

In summary, when it comes to questions about life insurance and "death taxes," with few exceptions, proceeds from properly written life insurance policies are exempt from federal and state income taxes, are exempt from probate fees when a beneficiary is designated, exempt from federal estate taxes in an estate valued under $5.25 million, and exempt from most state inheritance taxes. However, the "death tax" that has the potential to most affect readers is a state-level estate tax. Tax laws have been quite fluid during the past decade, so readers with estates that are worth over $1 million, including real estate, life insurance and investments, should consult with a tax professional about their status. Those who live in the states of Maine, Maryland, Massachusetts, Minnesota, Ohio, Oregon, New Jersey, New York, Rhode Island, and the District of Columbia currently face the most onerous state-level estate taxes.

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