

HASHEM and SIMMS, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

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Dear Client:

This letter will briefly summarize the income tax consequences associated with receiving the proceeds of a life insurance policy.

In general, the proceeds of a life insurance contract, paid by reason of the death of the insured, are not includible in the recipient's gross income. This exclusion is available without regard to who paid the premiums on the insurance contract or who owned the policy, so long as the beneficiary had an "insurable interest" in the life of the insured. Whether a beneficiary had an insurable interest is determined according to state law. In addition, life insurance contracts issued after 1984 must satisfy a complex federal income tax definition of "life insurance."

The beneficiary of a life insurance contract need not be a person, but may be a corporation, trust, partnership or estate. For example, creditors who are named as beneficiaries of a life insurance contract may generally exclude amounts paid by reason of the death of the insured. A corporation may also exclude death benefit proceeds from gross income, as may the shareholders of a corporation; however, an issue may arise as to whether payments received by a corporation's shareholders actually represented dividends.

It is important to keep in mind that generally only those amounts paid by reason of the death of the insured may be excluded from gross income. For example, payments which are in the nature of retirement benefits are not excludible. Additionally, payments to an insured's creditors must have been made by reason of the insured's death and not to satisfy a specific debt of the insured. Thus, a creditor must have had a legitimate reason, other than the creditor relationship, for having insured the debtor. (In some cases, amounts received by a person who is terminally or chronically ill may be treated as a "death benefit" and excludable from taxation).

The life insurance rules are complex. The rules regarding the federal income tax definition of life insurance require informed judgment to determine whether a particular contract meets the federal definition. For this reason, the facts of your situation should be carefully reviewed. Please contact us to arrange a meeting so that we can further discuss the tax consequences of life insurance.

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