Tax Reform Makes Life Insurance a Winning Strategy

Politics and the ultimate impact of an enormous national debt are combining to set us up for a new reality: higher taxes. Whether it comes in the form of new brackets, increased rates on capital gains, limitations on deductions for state and local taxes ("SALT"), or even tougher treatment of income earned in trusts, taxes are now impacting decisions on a much greater scale.

Quite often, as some approaches are made less attractive by tax law, other approaches become much more attractive, just by being outside of the tax target.

Such is the case with cash values held inside of life insurance contracts.

Cash values can grow without immediate taxation. Large amounts of cash value can be withdrawn without taxation, if the contract is tax qualified (most are) and if the amount withdrawn is no greater than the basis in the contract. In addition, cash values can be borrowed without taxation regardless of basis. And, by leaving a policy in force until a death claim is presented, the ultimate payout of the death benefit is fully tax free. If there was a loan, it is paid off out of the tax-free death benefit and the remaining funds are paid tax free to the beneficiary.

How do cash values grow? The drivers are the amount of premiums paid and the interest, dividends, or account value growth added to the cash value. While interest and dividends typically mirror bond rates, policies can also participate in returns based on equities, usually through allocation of the cash value to accounts similar to mutual funds or the more recent index approaches to policy returns.

The bottom line is that cash values can grow like other investments, but not suffer the cost of ongoing taxes.

Of course, the life insurance companies need to charge something for the death benefit they are providing. Those charges are typically applied against the cash value on a monthly basis. So, ultimately the question is whether the tax savings are greater than the cost of the insurance. Many regular corporations have answered this question affirmatively and acquired large cash values in what is known as corporate-owned life insurance (COLI). These cash values are used to fund any number of future liabilities, quite often retirement benefits for executives. The math for corporations can be different, however, since they do not have the ability to use the benefit of lower capital gains rates.

Wait! Did you say that corporations may use life insurance to avoid higher taxes on gains that would normally be considered capital gains? They pay ordinary rates on such gains. But what is happening to the capital gains taxes we pay as individuals? Capital gains taxes are going up. So are the ordinary rates on our dividend and interest income. Now we have new variables to consider in deciding how attractive it is to accumulate funds inside a life insurance contract. Maybe we will find that our situation drives the same answer that has caused corporations to choose life insurance for accumulation purposes.

For advisors who need to address this question with their clients, there are a few other variables to consider. First, make sure you look at a policy which has the lowest death benefit allowed without falling under the modified endowment contract (MEC) rules.

The lower the death benefit, the lower the insurance charges which can drag down the ultimate rate of return.

This makes new policies more attractive, since you can minimize insurance costs most effectively by building that approach from the beginning. Trying to "retrofit" an existing contract with a higher than necessary death benefit to now be an efficient wrapper for the accumulation of investment gains can be a difficult task.

Second, choose the form of cash value coverage wisely. We believe that contracts that pay fixed interest or dividends may underperform other types of cash value policies. The dividend-paying policies benefit from being based on the profitability of large and sound financial organizations, but that can also mean low returns. Those carriers must find a way to hold back funds to cover their guarantees and maintain their higher financial ratings. Alternatively, you might consider either a variable contract which can invest in a wide range of separate accounts or a universal life policy that offers indexed returns. With their cap rate and floor, the indexed policies will typically pay a little less on the upside in exchange for no downside (other than basic contract charges). Our expectation, not our guarantee, is that rates of return on this second group of policies will likely be more attractive, since historical capital markets in the United States favor the long-term return on equities over bonds.

Third, check and re-check the selected death benefit. New changes to IRC Section 7702 allow insurance companies to set lower death benefits per dollar of premium. By driving down the death benefit to the lowest amount possible, you will be decreasing the insurance costs and thus increasing the resulting rates of return. Carriers have re-priced their accumulation products during 2021 to fit the revisions to Section 7702.

In a future article we will discuss private placement life insurance, a related product for your very high net worth clients. These policies are typically quite large and offer you the ability to manage the investments yourself, offering the ability to employ certain strategies that are not typically available through mutual funds, strategies that otherwise might generate high levels of ordinary taxable income. Private placement policies offer the same tax benefits we have just been talking about above, only on steroids.

The best advisors watch for changes in the planning environment and react accordingly in the best interest of their clients. The ability to accumulate funds on a tax-favored basis inside of a life insurance wrapper is one of those advantages you don't want to miss. There are not many things worse than having your clients read about strategies that become obvious but which you have never presented to them. We believe that life insurance will become a mainstay for accumulation in the years ahead.

Want additional information or perhaps an example for one of your clients? Please contact AdvisorServe any time. We will be glad to help.

Greg Freeman
JD, CLU, ChFC, RICP, CLTC

Founding Principal, AdvisorServe