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Some Magical Aspects of Life Insurance

Posted by Jonathan Blattmachr – on July 28th, 2015

Life insurance is one of the least understood financial products in the world. In just a few minutes of study, one can reasonably grasp the concept of equity interests in a business (e.g., common stock, preferred stock), bonds and other forms of debt. Even more complicated financial products, such as derivatives and options can be readily understood.

However, even some people who have spent a career in the life insurance industry do not really understand the financial aspects of this product. Indeed, after finishing a lecture on how life insurance “works,” a 30 year life insurance agent came up to me and said, “Until today, I never really understood what I’ve been selling.” Once, when I asked another very successful CLU how many of his clients really understood what they were buying, he said, “virtually zero.”

It is way beyond the scope of this article to explain life insurance in full detail. **But, it is critically important to note that life insurance is not only a “different” financial product than virtually any other kind (e.g., stocks, bonds, hedge funds, bank accounts) but it is treated quite differently under many laws than other financial products or arrangements.** For example, the sale of most financial products is governed by the securities laws of the United States. But, as a general rule, these laws do not apply to life insurance policies; rather, **policies are governed by the laws of the various states.**

In many cases, the “different” treatment the law provides for insurance is a more favorable one. We will now look at three of these “legal” differences and how these differences can be used to accomplish superior financial planning.

Income Tax Free Compounding

Albert Einstein said two things that we believe we understand—we confess that we really do not understand “$e = mc^2$ ”. First, he said the most powerful thing in the universe is compounding. Allow us to offer a simple illustration of the profound effect of this concept. Imagine here are two people on earth. One has a greater propensity to have more descendants than the other. The first, and her descendants, have three descendants per generation. The other has two per generation. At the fifteenth generation, the first will have nearly fifteen million descendants while the other only 33,000. As a result, the earth will be controlled by the offspring of the first person and those of the second will disappear.

Second, Professor Einstein said that the hardest thing in the world to understand is the income tax. Few would disagree with that statement. The corollary we derive is that income tax free compounding is the most important factor in financial planning, as a general rule. Over a working lifetime, the amount available from tax free compounding may be several times greater than if the same return had been experienced and be subject to annual income taxation.

The United States tax law is miserly in granting tax exemption on profits. As an example, **the return on municipal bonds is not really tax free; rather, it is pre-taxed** (reflected in the lower interest rates they pay compared to the rates on comparable taxable bonds). **Retirement plans and annuities are not tax-free, but tax deferred. Tax deferral is powerful, but cannot compare to tax avoidance.**

Indeed, **there are only two ways an individual can experience true tax free returns. A Roth IRA and, you guessed it, life insurance.** The returns on any investment (or so-called "cash value") portion of life insurance grows income tax free (subject to certain exceptions which generally are easy to avoid) and, when the insured dies, are excludible from income taxation. In fact, **if structured as a non-modified endowment contrac**t under Section 7702A of the Internal Revenue Code (premiums paid over an extended period—e.g., ratably over five years), **the earnings may be borrowed income tax free and the inherent income tax liability is "forgiven" at death.**

So, if tax free returns are so powerful and that is provided, unlike Roth IRAs, essentially without limitation, in a "cash value" life insurance policy, why doesn't everyone invest that way? There may be several reasons. One is the failure to understand the power of tax free compounding. Another is that the owner of the policy has to pay for the underlying true insurance (that is, the mortality component under the policy, sometimes called the "net amount at risk" or "term insurance"). Also, insurance companies charge fees for managing the policy, which may be substantial. Moreover, there is a Federal charge on life insurance premiums (called the "deferred acquisition cost" or "DAC" tax) and all states charge a tax on premiums running about two percent (although on annual premiums above $100,000, Alaska and South Dakota charge only ten or eight basis points, respectively). In any case, all these taxes and costs are a drag on the return. However, these costs vary significantly from product to product.

Probably, the most efficient way to invest tax free in a policy is in one structured as a "private placement" policy. Essentially, it is a privately constructed policy often resulting in much lower costs for the mortality (term) component and lower fees and commissions. Hence, the drag on the investment returns is less burdensome, thereby allowing the policy owner to gain a much greater gross return than possible under a standard policy. Additionally, the owner has greater flexibility in determining the investments choices that the policy will offer and will not be limited to only those investment options the insurance company offers to standard policy owners.

There is another important, though rarely considered, factor when investing through life insurance. Many investment managers advise that they can produce higher gross returns when investing in a tax exempt investment environment, such as through life insurance. This is largely due to the fact that gains can be culled when considered for tax purpose to be short term without adverse tax consequences. Thereby, avoiding the risk of continuing to hold an investment in an attempt to convert the profit into lower taxed long-term gain. This can be particularly important if the manager believes the investment has reached a peak and may begin to decline.

Moreover, the manager can avoid culling losses on certain stocks without taking action to avoid the so-called "30 day wash sale loss rule," which denies the recognition of a loss if the security sold is repurchased within 30 days. Furthermore, in an income tax free investment environment, the type of return from a tax point of view (e.g., interest, taxed at ordinary income tax rates, or dividends, taxed at long-term capital gains tax rates) is unimportant. In fact, some managers are confident they can increase the return by more than the annual cost of the policy (so-called mortality and expense).

Step-Up in Basis

Now that the Federal estate tax exemption has been so dramatically increased (currently, $5,340,000 for 2014 and adjusted in future years for inflation) and the estate tax rates deceased (to 40%), the focus of many estate planners is now primarily on **income tax matters**.

There had always been a tension: removing assets from the property owner's taxable estate saved estate tax but such assets, at least in general, were denied the income tax free change in basis at the death of the owner. Since property over time tends to increase in value, this was typically viewed as a step-up in basis. However, avoiding high estate tax (which until recently was at 55% or greater) was a decent trade-off for losing the step up in basis, which merely avoided in most cases a long-term capital gains tax which, until recently, was at only 15%.

Now conditions have changed: the estate tax is much lower and capital gains tax higher–when coupled with the Medicare tax long term capital gains tax rate now reaches 23.8%.

Fortunately, with life insurance no loss of the equivalent of a step-up in basis occurs even if the insurance proceeds are not included in the decedent's estate. Proceeds of insurance paid by reason of the death of the insured are excluded from gross income, in almost all cases.

In addition, life insurance is probably the easiest asset with respect to which to avoid estate tax. Merely avoiding the ownership (technically, any "incident of ownership") of the policy (e.g., by having it owned by a family member or a trust) and having it pass to a beneficiary other than the insured's estate means the proceeds will not be part of the tax estate at death. Yet the proceeds, as stated, are not subject to income tax, even on the tax free growth, as explained above, on any cash value (investment) component of the policy.

Simplified Asset Protection

Much attention in recent years has been given to protecting assets from claims of creditors. Thousands of foreign and US asset protection trusts are created each year. While this planning no doubt increases the protection of trust owned assets, the true extent to which these trusts provide asset protection will depend on facts and circumstances present in each case.

However, under the law of almost all states, the entire interest in a life insurance policy, including the cash (investment) value can be elected to be free of creditor claims in bankruptcy. Hence, after the debtor receives a discharge in bankruptcy, he or she can surrender the policy and receive the entire cash value free of creditor claims. Even in those few states where that protection is not offered, it can be provided by having the insurance acquired by a trust for family members (a so-called "irrevocable life insurance trust" or "ILIT").

Although, as a general matter, all assets a decedent owns at death (or are in his or her revocable trust) are liable for his or her debts, life insurance proceeds, if not paid to the estate, are not responsible for those debts. Moreover, **if the proceeds paid at death are not included in the gross estate** (something, as explained above, relatively easy to arrange in most cases), **the proceeds cannot be taken by the IRS for payment of estate tax even on other assets.**

Summary and Conclusions

Life insurance is a unique financial product that can provide powerful financial and estate planning options. It is entitled to very favorable treatment under many security, tax and creditor laws that almost no other asset class may enjoy. Income Patrick and Tanya, a "living will" is your tax free (and not just deferred) growth, the equivalent of an income tax-free step-up right to die document, not a testamentary in basis at the death of the insured and protection from creditor claims are three instrument. Also, an "insolvent" estate is magical things insurance enjoys. It is worthwhile learning more about these matters one that does NOT have sufficient assets to so they can be more efficiently used for property owners.