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Is Life Insurance the Answer to the Proposed Tax Increases?

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Whether you have read the U.S. Treasury's "Green Book"[1] cover to cover, or simply glanced at the National Debt Clock in Manhattan recently — there seems to be ample evidence that taxes may be rising in the near future. What specific taxes will be changed, the exact level of increase, and when the new rates will take effect will be as much discussed (and, of course, lobbied against) as the speculation run-up to the Kentucky Derby. Leaving the ultimate taxation outcome conjecture aside, this article focuses on the fundamentals of how life insurance is positioned in the I.R.C. and how this financial tool can be utilized to mitigate the impact of increased taxation on individuals and families.

LIFE INSURANCE 101: IT'S THE INSURANCE BENEFIT, STUPID

In the 1992 U.S. Presidential race, James Carville (chief campaign strategist for former President Bill Clinton) famously wrote, "It's the Economy, Stupid" on a campaign HQ white board. Clearly, there were other important campaign issues, but Carville's belief was that the economy was paramount. With life insurance, the most fundamental tax benefit is that, in general, insurance benefit proceeds are paid in cash and received by the policy beneficiary exempt from income tax §101(a)(1).[2] This includes all types of life insurance and any accumulated gain of a policy's cash value, assuming that a policy has met the applicable definition of being "life insurance." Life insurance has other tax dynamics and attributes that this article will cover, but as Carville's identification of the Economy led to election victory, it is the income tax-free insurance benefit that will likely prove most important to family planning as the proposed tax changes take effect.

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[1] General Explanations of the [Biden] Administration's Fiscal Year 2022 Revenue Proposals, Dept. of the Treasury (May 2021).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

Utilizing life insurance to create a pool of liquidity (read: cash) has always been a prominent planning rationale. The flexibility that comes with having cash on hand for current expenses, taxes, buy-outs, etc., will likely grow in importance if the government's pattern of creating uncertainty through changing tax dynamics and rates continues. Rarely has an executor, or other estate advisor, around the settlement table not welcomed having cash — usually they are looking for more of it!

TWO PRIMARY TYPES OF LIFE INSURANCE

In general, there are two primary categories of life insurance – term insurance and permanent (or Cash Value) insurance. A reasonable analogy for distinguishing the two is renting versus owning. Term is like renting (an apartment), i.e., a pure cost; and permanent insurance is like owning (a home), i.e., it builds equity. This is not a judgement on one over the other, as both types play important roles in a client's lifetime of planning needs.

Term insurance policies typically have a level period where the premium for coverage, once issued, is locked-in (guaranteed) for a certain period, e.g., 10, 15, 20 years, or longer. Coverage can be continued at the end of the term period, but the premium rises dramatically and is usually cost prohibitive. Term insurance is best suited for covering short-term mortality risk for any number of reasons, including: income replacement, the cost of education, key-person business needs, buy-out capital for a business buy-sell, etc. As important as the coverage is if an early death occurs, it is equally important to understand that the vast majority of term policies never pay out as a claim (it is estimated less than 2%).[3] This is largely because premature death is rare and term insurance is reasonably priced before maturity, but not when death is most likely to occur. It is also important to note that as a general rule, life insurance premiums—whether term or permanent—are not tax-deductible in either family or business planning scenarios.

PERMANENT (CASH VALUE) LIFE INSURANCE EVOLUTION: A VERY BRIEF HISTORY

There are several types of permanent life insurance, with the two main distinguishing features being how premiums are required to be paid and how the cash value (equity) of the policy grows. The oldest example of permanent life insurance is Whole Life (WL), i.e., for one's whole life. Often, "Whole Life" is used to describe permanent insurance; however, distinguishing the specific form of permanent (cash value) policy is important, as features, guarantees, premiums, investment options, etc. vary greatly among the various forms of permanent policies.

WL still dominates the labeling of permanent insurance because for the majority of the 20th century, the life insurance marketplace was simply comprised of only term and WL. WL insurance has a fixed premium and economic results that are based on the dividend crediting rate and expenses of the insurance company.

Societal changes in America in the 1970's brought additions to the products offered by life insurance carriers. For example, as more married women entered the workforce family incomes increased, as well as the need for financial security planning. High interest rates in the late 1970's drove the development of Universal Life (UL) insurance. The marketplace demanded a more flexible premium option, which UL offered, as well as a "crediting rate" (rate of return) that was more easily identifiable than the "black box" dividend process of WL. Like today, higher tax rates increased the market's appreciation for the tax-deferred growth factor of life insurance and by the early 1980's most all major life insurance carriers had created a UL product.[4]

In short, the invention of UL launched a wave of life insurance product development that has continued through today. As the growth of the mutual fund industry's offering grew through the late 1970's and 1980's, Variable Universal Life (VUL) was created to combine investment returns with the tax-deferred nature of life insurance and to keep pace with general innovations in the investment marketplace. VUL required advisors to be insurance and securities licensed, as it is considered a security and regulated as such.

Today, there are at least seven core forms of permanent life insurance: Whole Life (WL), Universal Life (UL), Guaranteed Universal Life (GUL), Index Universal Life (IUL), Variable Universal Life (VUL), Guaranteed Variable Universal Life (GVUL), and Private Placement Variable Universal Life (PPLI). The diversification of life product offerings, along with options and features has never been greater, thus giving tremendous flexibility and choice.

THE REWARD-RISK RATIO: OTHER KEY TAX FUNDAMENTALS OF LIFE INSURANCE

Along with income tax-free insurance benefits, life insurance products provide other favorable tax funda-

[3] A Penn State study completed in 1993 said that less than 2% of all term life policies paid a death claim, and that less than 10% of all term policies stayed in force during the entire initial term period. Penn State University, 1993 Study.

[4] Douglas C. Doll, A Brief History of Universal Life.

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mentals. Life Insurance Policy Cash Values accumulate on an income tax-deferred basis per §7702(g)(1)(A). This means that the asset growth (investment gains above premiums paid) of the cash value component of a permanent life policy avoids any income or capital gains taxes as long as the policy remains in-force (active) and the policy is ultimately paid out as a death claim. This tax treatment ''reward'' has a ''risk'' side- if a policy is surrendered (cancelled), the gain (calculated as the difference between the total cash value and the cost basis of the policy) is subject to ordinary income taxation. Therefore, life insurance should be proactively managed, like any other asset. Too often the consumer sets their insurance and forgets it. Service and policy management is important with all life insurance products, and that importance grows with the financial complexity of both the family and the policy portfolio. Worth noting is that losses in a life insurance policy (if surrendered) do not reduce taxable income.

Another tax fundamental of life insurance is that the assets, or cash value, inside a permanent life insurance policy may be reallocated within the policy without income or capital gain taxation.[5]

This is most germane to variable life insurance products, which have a selection of separate accounts (or sub-accounts), that look like mutual or investment funds with a wide variety of asset classes from which the policy holder can choose. The policy's account options look similar to a 401(k) menu, often with dozens of investment options. Private Placement Life Insurance (PPLI) offers accredited investors and qualified purchasers a host of non-registered ''alternative'' investment funds to allocate among. Families often invest in in tax-inefficient asset classes such as credit funds or other high turn-over funds through PPLI because they can do so without recognizing taxable income. This tax fundamental allows tremendous asset allocation and rebalancing freedom. This flexibility of life insurance may prove of particular value, given the current tax proposals for increases in capital gains and ordinary income tax rates.[6]

Further, cash distributions from life insurance is calculated upon the FIFO (First In, First Out) accounting method, meaning the first dollars in are the first dollars that come out. Thus, the cost basis (premiums paid) of a permanent policy may be ''withdrawn'' from a policy without any tax consequences; the policy owner is simply getting their premium dollars back out of the contract (assuming a Non-Modified Endowment Contract, or Non-MEC). Owners of life insurance wanting additional dollars (during their lifetime) beyond the cost basis (premiums paid), can take a tax-free policy loan. The insurance company will charge interest on the loan based on an interest rate determined by the insurance company. Access to liquidity through policy withdrawals and loans can be accomplished cost effectively, and as much as roughly 80% of the cash value can be accessed, but not without some risk. That risk is of policy lapse, i.e., if the policy cash value is diminished, through insufficient returns, and can't support the cost of the insurance benefit. In this case, the gain above the premiums paid would be subject to ordinary income tax under §72(e)(3). This outcome is best avoided by thoughtful consideration and analytic modelling of the effect of such policy loans, i.e., good policy service. Policy loans are paid back to the insurance company through an offset of the insurance benefit. As noted earlier, when the policy pays out, even the net-after loan proceeds, it is received income tax-free by the beneficiary. Thus, when executed effectively, the owner was able to access and capitalize on the growth of the cash value in a tax-efficient manner.

SECTION 1035 EXCHANGES AND LIFE SETTLEMENTS

It could be argued that the U.S. government built the tax fundamentals of life insurance into the I.R.C. as a recognition that Mark Twain may have been onto something when he said, ''never put off till tomorrow what may be done the day after tomorrow just as well.'' In other words, there was a need to motivate citizens to create plans for their eventual passing and tax incentives help that motivation. In similar fashion, the government was forethoughtful in recognizing that over time the life insurance consumer marketplace experiences and develops both pricing improvements (e.g., extended life expectancy and other cost saving factors) and product innovations. Thus, it created §1035 to allow consumers to exchange an old policy for a more favorably priced new one without having to surrender the old policy and recognizing taxable gain. Done properly, the exchange is tax-free and the cost basis of the old policy is carried over to the new policy.

The primary §1035 conditions that must be met include: both the insured and the owner must be the same on the new and old policies; a life insurance policy can be exchanged for another life insurance policy, an annuity, or a qualified long-term care contract. From a procedural standpoint, the existing policy is surrendered and assigned directly from insurance company to insurance company. Such exchanges must be done thoughtfully and with thorough analysis to determine if the advantages to a new policy outweigh any costs of doing so.

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[5] §7702(g)(1)(A); Rev. Rul. 81-225, Rev. Rul. 82-54.

[6] Harold D. Skipper and Wayne Tonning, *Advisor's Guide to Life Insurance 2011*.

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Life Settlements are when a policy is sold to an unrelated third party for an agreed upon price (willing buyers and sellers). This secondary marketplace (the primary life insurance market being policies acquired directly from insurance companies) grew out of ''Viatical Settlements'' that the HIV/AIDS epidemic created in the 1980's, as policy holders sought advances on insurance proceeds to pay for life extending therapies. Rather than surrendering the policy for the cash value, the policy owner can often sell the policy in the secondary market for more value. Life settlements are most appropriate for insureds over age 65. Unrelated third parties that acquire such policies do not have an insurable interest in the life of the insured, thus an income tax is imposed on any gain received (at policy maturity). The owner of the policy has a tax upon sale too. This tax is partial ordinary income (gain of cash value over premiums paid) and part capital gains (difference between sale price of the policy and the cash value.

Given the tax realities, one might ask why a consumer would give up a tax-free benefit to a third party who is willing to pay tax on the gain? It is a reasonable question and after exploring a settlement, many conclude to retain their policies. The planning circumstances where selling meets planning goals include: no more need for the coverage; premiums are no longer affordable; and a need for immediate cash. The secondary market has created an additional exit strategy and an alternative to surrendering coverage no longer needed, thus it is indicative of the broader flexibility found in today's life insurance planning.

EXCEPTIONS TO THE GENERAL RULE

It is important to note that there are certain exemptions to the general rule that life insurance benefits are income tax-free. The primary two exemptions are receipt of some employer-owned life insurance and certain transfers of a policy during the insured's lifetime for value. The latter, so-called ''Transfer for Value'' rule states that if a transfer of a policy for value has occurred during the insured's life, the insurance proceeds will be includable in the beneficiary's taxable income. There are a number of exemptions to the general Transfer for Value rule. Those are beyond the scope of this article, but if a policy has been transferred at any time, the rules must be explored and understood to confirm a tax-free insurance benefit will be received.

MARKETPLACE UPDATE

As reported in the March 13th, 2020 issue of this publication[7]and updated in the September 10th issue,[8] life insurance carriers recently had major product pricing and reserving changes driven initially by the implementation of the 2017 Commissioners Standard Ordinary Mortality Table (CSO Tables), which required (by January 1, 2020) that United States Life Insurer pricing follow the updated table. Just when life product pricing actuaries had completed said changes to all products, Coronavirus (Covid-19) hit the population. Its effect on the economy prompted the Federal Reserve to lower interest rates to nearly 0% in March of 2020, which forced life insurance carriers to have yet another round of product pricing adjustments and underwriting changes — the most change in the shortest period of time the industry has ever experienced. This environment of low interest rates and increased sensitivity to death from Covid-19 challenged life insurance companies and led to a multitude of industry product and procedure changes. The result is an evolution of more products whose performance is driven by factors other than the yield on the insurance companies' general account. Many of the new products and features provide an opportunity for clients to significantly enhance the economics of their existing insurance portfolios or find attractive investment alternatives (returns) that have only recently been available.

CONCLUSION

To motivate planning that is not always easy for humans to accomplish, life insurance has unique tax benefits (tax-free insurance benefits, tax-deferred growth, and tax-free re-allocations) not found with other financial solutions. These features have long played an important role in risk mitigation and planning strategies for families, irrespective of market conditions, political climate, and tax rates. However, the products' unique tax features do offer additional value when taxation is higher. Today's political and social climate as well as the national debt will likely drive taxes higher. As in other times in history, life insurance is positioned to provide a safe harbor during stormy weather. Given the recent product proliferation

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[7] Holleman and Maeda, *Life Insurance Policy Re-Pricing: What Drove the Changes and What It Means for Policy Owners and the Marketplace*, 45 Tax Mgmt. Est., Gifts & Tr. J. No. 2. (Mar. 13, 2020).

[8] Holleman and Maeda, *Life Insurance Policy Re-Pricing 2.0: Life Insurance Companies Adjust Quickly to 2020 Covid-19 Driven Impact,* 45 Tax Mgmt. Est., Gifts & Tr. J. No. 5. (Sept. 10, 2020).

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and the current estate tax laws — especially the Lifetime Exemption amounts (which will sunset at the end of 2025) — it is an ideal time to explore the tax savings and planning benefits of today's life insurance.

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