The Role of Cash Value Life Insurance in Tax Diversification

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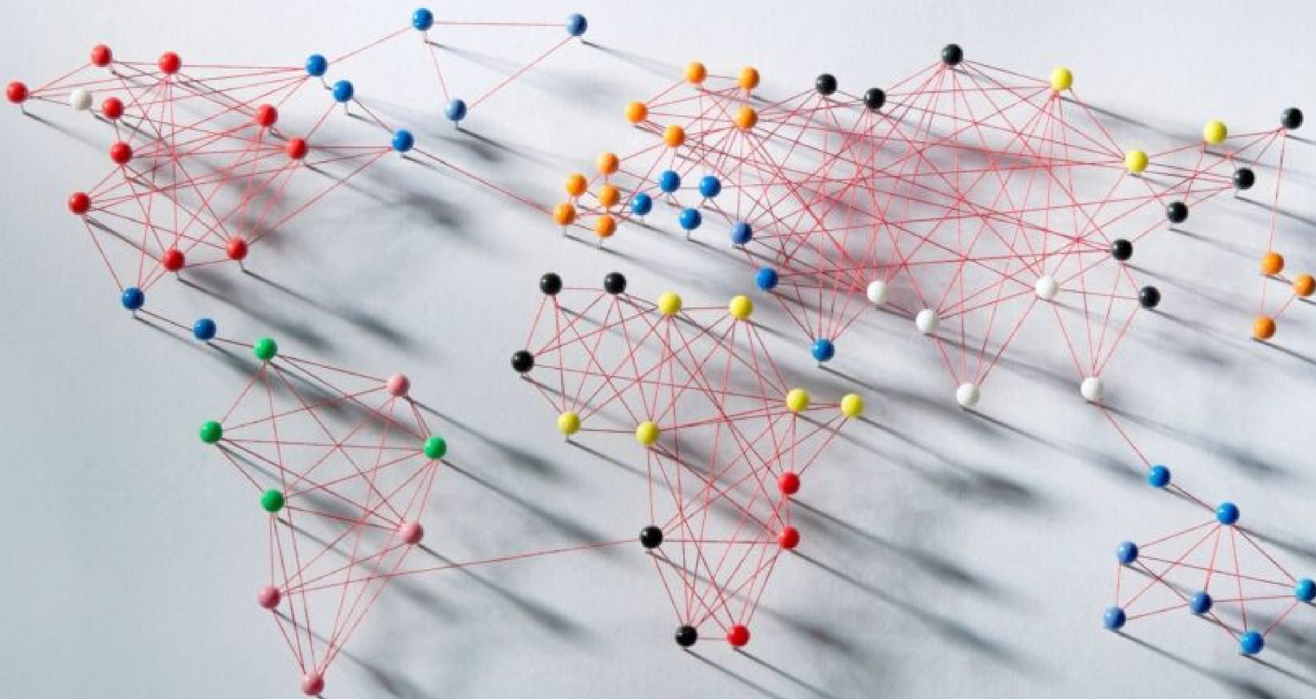


Politician, clergyman, and athlete J.C. Watts said, “Death and taxes may be inevitable, but they shouldn't be related." Unfortunately, this relationship is where high net worth individuals and families focus their wealth and estate planning – on addressing taxation at the end of their lives. Estate taxes can certainly have a profound and negative impact on wealth, but this effect can be mitigated by more efficiently growing and preserving capital over one’s lifetime through diversification techniques. These techniques should not be limited to diversification of asset classes in a portfolio to support capital growth but also consider tax diversification to prevent the erosion of capital.

Leakage

In his book, “Wealth: Grow it, Protect it, Spend it, and Share it”, wealth manager and heir to the Carnation Company fortune, Stuart E. Lucas discusses the attrition of wealth as capital leakage and the strategy of diversifying the tax treatment of assets to address it. Capital leakage comes in several forms:

- Spending,
- Income taxes,
- Estate taxes,
- Market or interest rate risk,
- Inefficient asset allocation,
- Inflation,
- Liabilities (including healthcare and legal matters), and
- Dilution of wealth attributed to family growth

Tax diversification is derived from owning assets across various tax treatments. As a variety of assets are accumulated, it is important to understand how each asset will be treated now and in the future. Since tax rates for all assets are not the same and do not rise and fall together, the tax treatment of assets should be planned for through diversification to mitigate tax leakage. This provides the ability to hedge against future tax rate volatility and to take advantage of future tax rate decreases.

The three asset class zones of tax diversification are best described as Tax Now, Tax Later and Tax Never.

Tax Now

Taxes are due when assets are sold at a gain.

- Stocks
- Bonds
- Real Estate
- Mutual Funds
- Private Equity
- Alternative Investments

Tax Later

Taxes are due when the funds are withdrawn from the account.

- Qualified Plans
- Annuities
- Traditional IRAs

Tax Never

Taxes are never due given their tax-advantaged treatment.

- Municipal Bonds
- Roth IRA
- Cash Value Life Insurance

An allocation of capital across all three zones can mitigate the effective income tax rate and stabilize a portfolio for a client.

The Role of Cash Value Life Insurance

High net worth individuals face distinctive challenges when segmenting asset classes where all tax-advantaged asset classes are either unavailable to them or have limited value in their portfolio. For instance, qualifying for a Roth IRA is extremely unlikely and the funding limits of qualified plans restrict the percentage of wealth which can be allocated. Conversely, these individuals commonly have more allocations to highly tax-inefficient investments like private equity, hedge funds and real estate. In balancing their tax diversification strategy, the wealthy are increasingly turning to 'Tax Never' cash value life insurance.

Tax Code Section for Life Insurance

IRC Sec. 101	Life Insurance Death Benefits are Tax Free
IRC Sec. 7702	Definition of Life Insurance for Tax Deferred Growth
IRC Sec. 7702A	Modified Endowment Test for Life Insurance
IRC Sec. 72	• Withdrawals to Basis and Policy Loans from Non-MEC Life Insurance are Tax Free
	• Exclusion Ration for Amounts Received as Annuities
	• Distributions from Annuities and MEC Life Insurance are Taxable to Extent of Gain plus 10% Penalty if Under age 59 1/2

Individuals are discovering what major financial institutions have known for several decades – cash value life insurance possesses unique tax benefits which can be positioned both as a contingent asset class to balance risk and return in a portfolio and as an effective tool for tax diversification. These institutions are most often targeting the 'Tax Never' category by allocating as much of their Tier I capital as allowed by regulators to life insurance. This is the core capital a financial institution holds in its reserves and exists as the primary source of funds. Typically, variable life insurance policies are purchased where the cash value is segregated from the general account of the insurer and not subject to the insurer's creditors, providing asset protection.

Bank-owned Life Insurance ("BOLI"), Corporate-owned Life Insurance ("COLI") and Insurance Company-owned Life Insurance (yes, even insurance companies purchase policies from one another!) ("I-COLI") strategies all target either using income tax-free cash value loans or income tax-free death benefit to off-set or fund a multitude of liabilities which would otherwise erode capital. Effectively, cash value life insurance is used to silo cash at greater rates of return. Wealthy individuals can also take advantage of the death benefit and accumulation attributes of cash value life insurance in a similar fashion as institutional investors.

Death Benefit

The traditional positioning of life insurance by the investment community tends to only consider the expected return realized on the income tax-free death benefit when it is paid. This is computed by measuring the return of the death benefit against the premiums paid over time. At life expectancy, most clients will realize a return from a cash value life insurance policy ranging between 5% and 7% on an after-tax basis. These projected returns fall in the middle of the double digit returns expected from private equity and the low single digit returns government bonds generate.

Those with more experience in this space will find this traditional method incomplete and will want to take two additional steps for a complete asset class analysis as laid out by economists Harry Markowitz in 1952 and William F. Sharpe in 1966. Markowitz's Modern Portfolio Theory theorized that, in addition to determining an expected return, individual portfolio assets should also be analyzed for their expected risk, which is the risk of not achieving the expected return.

> "Diversification is the only free lunch [in investing]."
>
> Harry Markowitz
> Nobel Prize Laureate

The second step to complete an asset class analysis relies upon the Sharpe Ratio to measure the performance of an investment, such as a real estate investment or a security in a portfolio, compared to a risk-free asset, like cash, after adjusting for its risk. The Sharpe Ratio characterizes how well the return of an asset compensates the investor for the risk taken and is used to compare one asset against another to achieve the optimal portfolio based upon a client's risk tolerance.

The result when analyzing cash value life insurance is that the income tax-free death benefit has a very stable expected return and a low risk of not obtaining that return. This makes it ideal to use to hedge against riskier asset classes such as private equity and hedge funds which are also highly taxed and lead to significant amount of capital erosion. By including a life insurance policy, an individual is effectively adding a hedge with built-in tax diversification to a balanced portfolio.

Accumulation

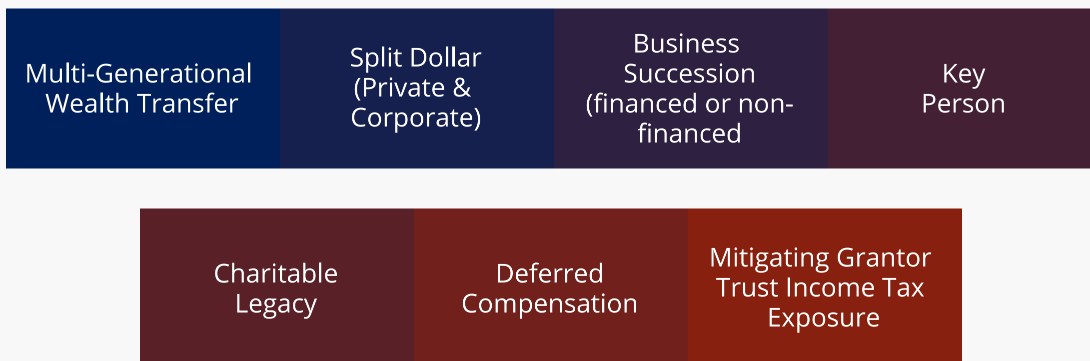
Tax treatment of a policy's cash value goes beyond the well-recognized benefit of tax-free growth of premiums as a part of a policy's cash value. During someone's lifetime, a cash value life insurance policy is a preferred source of liquidity on par with cash in a checking, saving or money market account. When structured as a non-modified endowment ("non-MEC"), through as little as three annual premium payments, a policy's cash value can be accessed in the form of extremely low interest and tax-free loans which remain tax-free as long as the policy remains in-force.

The tax-free nature of policy loans means that the rate of return to the policyholder can be expected to be similar to after-tax returns of other assets bearing greater investment risk, providing tax diversification. Perhaps best of all, when there is a need for cash, a client's own asset, their cash value life insurance policy, can serve as their bank, complete with a preferred rate and terms.

Estate Planning

The traditional role of life insurance in estate planning in today's increasing tax environment is as important as ever and should not be discounted when considering tax diversification. Removing capital from being exposed to federal and state estate taxes is the goal of estate planning. Assets moved into irrevocable trusts through the use of estate and gift tax exemptions fall into the 'Tax Never' category as they escape estate taxes. The benefit of this strategy is further amplified by the compounding growth of the assets held outside of an estate for heirs who can look forward to receipt without erosion to taxation.

Planning Opportunities for Cash Value Life Insurance



The Policy

Three types of cash value life insurance policies provide wealthy individuals the structure and flexibility to integrate into a tax diversification strategy: Indexed Universal Life ("IUL"), Private Placement Life Insurance ("PPLI") and Variable Universal Life ("VUL") with indexing options.

IUL gives the policyholder the opportunity to earn interest and grow the cash value of the policy faster than with a regular universal life contract. Instead of the insurance company only declaring a fixed, low crediting rate, the policyholder also has the option of linking performance to an index and earning, to a degree, what that index earns (excluding dividends). Popular indices include the S&P 500 and the NASDAQ 100.

IUL contracts mitigate potential negative index returns by setting a guaranteed minimum performance level, usually 0%. The contracts then offset the financial cost of the minimum guarantee by capping returns at attractive but not 'windfall' rates. Policyholders are able to obtain market-like returns with downside protection.

PPLI is a variable type of cash value life insurance where purchasers must be either an accredited investor or qualified purchaser and be prepared to contribute at least $1 million a year in premium. Those considering PPLI are most interested in (a) being able to choose customized or bespoke investments within the policy; (b) to see the value of those investments grow tax deferred; and (c) to later access money income tax-free or pass it to heirs income tax-free. Investment choices include insurance versions of popular alternative investments or discretionary managed separate accounts.

Cash Value Life Insurance

Indexed Universal Life (IUL)	Private Placement Life Insurance (PPLI)	Variable Universal Life Insurance (VUL)
Link general account cash value growth to popular indices	Policyholder chooses underlying policy investments, investment manager and custodian	Policyholder chooses from a list of underlying policy investments
Offers downside protection	Institutional pricing	Unlimited upside potential
Upside is capped	Unlimited upside and downside	Downside protection via index options and guarantees

The choice of a PPLI policy is generally made for investment purposes to maximize cash accumulation, and not for traditional life insurance needs where a large amount of coverage is sought. The PPLI client typically wishes to only purchase the minimum amount of life insurance the IRS requires for the policy to be deemed life insurance and not an investment.

VUL is a variable type of cash value life insurance where the underlying investment options are sub-accounts like mutual funds. Several carriers now offer a hybrid between the traditional VUL and IUL policy by allowing the policy owner to allocate the account value to indexed accounts that were historically only offered in an IUL policy.

IUL, PPLI and VUL policies permit a large amount of premium. This can make a policy of sufficient size to have a meaningful impact on the policyholder's tax diversification through the 'Tax Never' attributes of cash value access and stable death benefit returns.

Plan Now

Do not assume that tax rates will remain constant over time. Looking forward two or three decades, tax rates will undoubtedly change multiple times and recent government spending points to increased austerity measures in the form of higher taxes. It is never too early to commit to tax diversification and immediately benefit from a reduced effective tax rate by allocating a portion of cash to the 'Tax Never' category asset of cash value life insurance.

About the Author

Terry Navarro, CPA is the Co-Founder of JNJ & Associates, Ltd, an independent life insurance brokerage firm. JNJ & Associates, Ltd designs, implements and monitors life insurance portfolios to assist clients in successfully preserving their private capital through multiple generations and enhancing their business and philanthropic endeavors. The alternative is to allow wealth to become exposed to income and estate taxes.