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Tax Mitigation for the Highly Taxed: The Hidden Benefits of Life Insurance

As we look ahead to the new year, high-income earners face increasing complexities in tax planning and wealth management. Life insurance is emerging as a tool that not only provides a safety net for loved ones but also serves as a sophisticated strategy for tax-deferred savings. High income earners often max out their tax deferral options, having fully contributed to their 401(k)s, Health Savings Accounts (HSAs), and Traditional/Roth IRA options. Insurance can provide another avenue by which to pursue unique tax advantages.

With foresight and planning, life insurance policies can be designed to maximize cash value growth rather than just the death benefit, offering a tax-efficient vehicle for retirement savings. This approach can help mitigate the impact of taxes on specific assets over a long horizon, making it a valuable component of a comprehensive retirement strategy.

Challenges for High Income Earners

37%	Top Income Tax Bracket
20%	Long-Term Capital Gains
3.8%	Net Investment Income Tax
0.9%	Additional Medicare Tax

Contribution Limits

85% of Social Security Benefit May Be Taxable

Increasing Heath & Long-Term Care Expenses

THE ADVANTAGES OF USING LIFE INSURANCE

Life insurance policies are typically designed to maximize the death benefit, but this is not always necessary. Alternative designs can enhance cash value growth potential, creating a pool of funds for the policy owner to access. The threefold tax benefits of life insurance are:

Tax-Deferred Accumulation[1]

Tax-Free Access to Cash Value[2]

Tax-Free Death Benefit or Long-Term Care[3]

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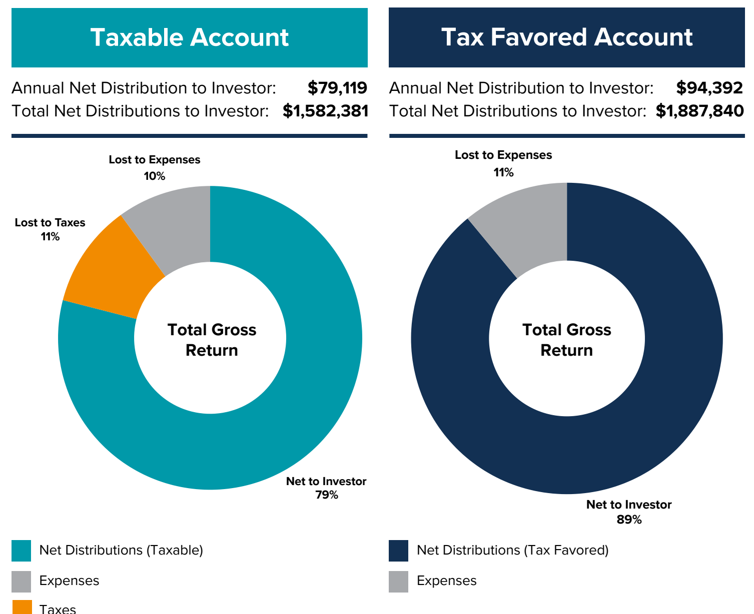
Intelligently designing life insurance with a lower death benefit can fuel higher cash value growth by reducing fees typically associated with the death benefit. The owner can access the cash value up to their initial investment in the policy without paying taxes. After withdrawing their initial investment, the owner can then borrow from the policy's cash value while still being excluded from taxable income. Building this flexibility into a policy provides high-income earners with an additional means of saving for retirement in a tax-favored wrapper.

WHO IS THE IDEAL CLIENT?

- High-Income Earners-making $200,000 or more annually
- Individuals that have maxed out tax-advantaged retirement savings options
- Individuals with a 10+ year timeline to allow funds to accumulate

CONSIDER THE IMPACT OF TAX SAVINGS VS. INSURANCE CHARGES

Taxable accounts lose some performance every year from expenses and taxes. Even index funds create taxable dividends. Tax Favored accounts may have higher or lower expenses but do not incur taxes. Your best account type depends on your situation, such as age & health, tax situation, time horizon, investment strategy, and risk tolerance. The main reason to have a life insurance policy as a tax-favored account is for the death. For many people saving for retirement, there is a difference between what you need and what you have. This is how a skillfully designed policy can serve two goals: provide for your family while saving for retirement and give you income in retirement.



Male, age 45 taking income for 20 years starting at age 67. Contributions of $25,000 annually for 22 years at a gross annual rate of return of 7.00%. Analysis assumes allocation to 70% equities and 30% Fixed Income assets, assessing a 37% Ordinary Income tax rate and a 20% Capital Gains/Dividends rate (24% Ordinary Income and 15% Capital Gains/Dividends rate in distribution phase).

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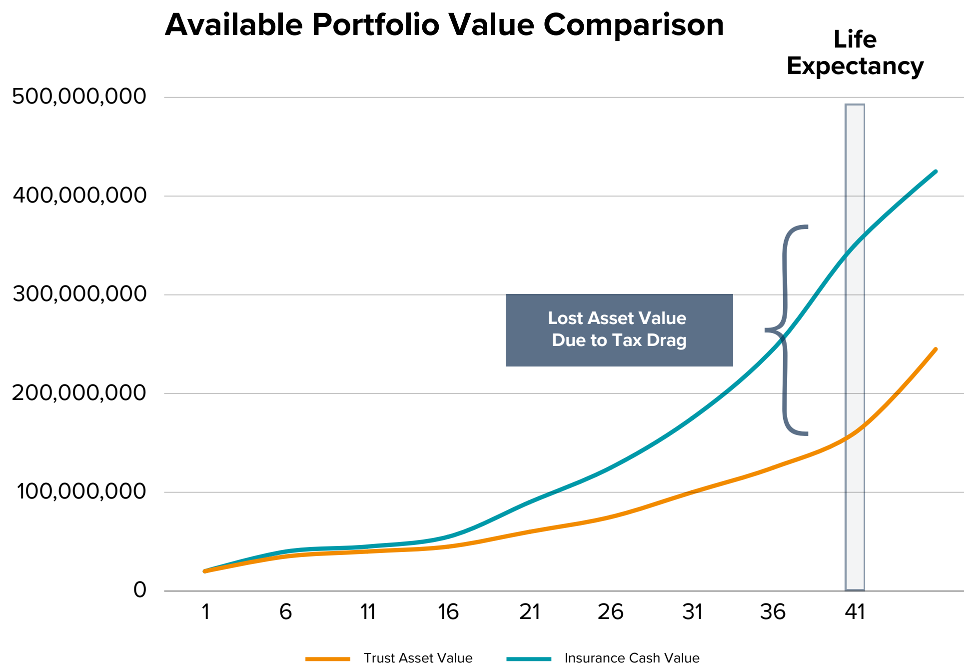

(1) Hypothetical example of the impact of taxes on investable assets over time vs. the power of tax-deferred compounding through insurance.

Along with traditional retirement savings, life insurance can help you reach the financial freedom you want.

KEEP IN MIND

Life insurance can be a robust solution, as with many retirement planning options, there are limitations to what life insurance can do. It is imperative that the policy avoids a Modified Endowment Contract (MEC). If premiums exceed guidelines limiting premium-to-death benefit ratios, the policy will not be granted the same tax benefits. Instead, access to cash value will resemble what is used for annuities and treated on a last-in-first-out (LIFO) basis. The result: any withdrawal or loan from the contract will trigger the gain in the policy to be recognized as ordinary income. Like other retirement planning options, distributions from a MEC policy may also be assessed an additional penalty tax if the policy owner is under 59 ½ years old.

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Additional considerations should be given to the long-term policy performance. Loans from a life insurance policy are generally not taxable, but a policy may terminate with an outstanding loan during the insured's lifetime. In this case, the total loan balance—including accrued interest—may be considered phantom income to the extent there is gain in the contract. Some policies can help avoid this lapse through a policy feature called an overload protection rider. However, death benefits remain tax-free, even with an outstanding loan.

Life insurance offers tax benefits to help high-income owners boost their retirement income and savings. They can gain more value from their money now and leave a death benefit for their family later.

Questions? Contact:

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DISCLOSURES
1. Internal Revenue Code §7702

2. Internal Revenue Code §72(e); in general, a life insurance contract not considered a Modified Endowment Contract (MEC) is taxed on a First-In, first-Out FIFO) basis, providing that withdrawals of basis are considered non-taxable distributions and loans against the policy are generally not considered to be taxable distributions.

3. Internal Revenue Code §101(a) and Internal Revenue Code §7702B of Internal Revenue Code §101(g)

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