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MARKETING INTELLIGENCE REPORT

June 2014

Life Insurance in a Rising Tax Environment

As Planning Priorities Shift and Tax Rates Increase, Life Insurance Remains an Effective Solution

Advisors and high net worth (HNW) individuals with federal estate tax exposure have long relied upon life insurance as a sophisticated planning tool. Life insurance offers a unique combination of liquidity, leverage, and flexibility, with the ability to fund future obligations.

As effective income tax rates continue to increase, the unique features of life insurance, including its income tax treatment, become increasingly appealing. Life insurance is purchased with after-tax dollars, and the gain on inside buildup is not taxed when held within the contract consistent with treatment of appreciation on stock or home values.¹

HNW taxpayers will likely benefit from a review of planning strategies that allow for income tax-deferred growth, including life insurance. In addition to HNW taxpayers, high-income earners (HIE), or those with earned income extending into the top tax brackets, also benefit from life insurance as part of their overall financial portfolio.

The Increasing Income Tax Environment

Both HNW and HIE taxpayers have been subject to substantial income tax increases in recent years. Federal tax law developments affecting HNW and HIE taxpayers in 2013 and beyond include:

Income Tax Changes	2012	2013+
Top Federal Income Tax Rate ^{1,2}	35%	39.6%
Pease Amendment ^{1,4}	No	Yes
Personal Exemption Phaseout ^{1,4}	No	Yes
Payroll Tax Changes		
Medicare Payroll Tax Surcharge ³	0%	.9%
Social Security Payroll Tax - Employee ⁵	4.2%	6.2%
Social Security Payroll Tax - Self Employed ⁵	10.2%	12.4%
Investment Tax Changes ⁶		
Short-Term Capital Gain	35%	43.4%
Long-Term Capital Gain	15%	23.8%
Qualified Dividends	15%	23.8%

¹American Taxpayer Relief Act (ATRA) of 2012.

²Modified Adjusted Gross Income threshold of more than \$400,000 (individuals) or \$450,00 (joint filers).

³Patient Protection and Affordable Care Act of 2010. Modified Adjusted Gross Income threshold of more than \$200,000.

⁴Modified Adjusted Gross Income threshold of more than \$250,000 (individuals) or \$300,00 (joint filers).

⁵Payroll tax holiday expiration. SS wage base limit of \$110,100 in 2012 and \$113,700 in 2013.

⁶Includes 3.8% Unearned Income Medicare Contribution Tax.



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1 AALU: Life Insurance Provides Financial Security & Peace of Mind (2014).

Life Insurance in a Rising Tax Environment (continued)

The cumulative impact of federal income, investment, and payroll tax hikes substantially increases the tax burden of top-bracket taxpayers. Tax changes are also occurring at the state level: California voted to pass Proposition 30 in 2012, resulting in state income tax increases of 1-3% for HIE taxpayers. HNW and HIE taxpayers will be increasingly motivated to consider the tax efficiency of different asset classes, and will likely favor deferral strategies that shift income and tax payment into the future, where the taxpayer may anticipate being in a lower tax bracket.

Cumulative Impact of Tax Increases

The impact of these recent income tax increases is most noticeable when comparing overall tax liability in 2012 to 2013 and beyond. The Tax Policy Center has noted upper-income taxpayers would experience the largest tax increases, both in absolute terms and as a percentage of income. Households in the top 1% of the income distribution would see an average tax increase of more than \$120,000, with their overall federal tax rate rising from 31.2% to 38.4%.² These projected increases do not include the impact of the payroll tax holiday expiration or state income tax increases.

The Case for Life Insurance

Advisors frequently view life insurance as a way to mitigate the financial consequences of untimely death. As such, life insurance is often designed to minimize premium cost, measuring success based upon the policy's internal rate of return (IRR) at the insured's life expectancy. Death benefit IRR at life expectancy is a valuable measure of a policy's effectiveness; however, cash accumulation features within permanent policies can build significant value during lifetime for HNW and HIE taxpayers and should also be considered in the context of life insurance and financial planning.

These living benefits may be used to help achieve a wide range of financial objectives including: cash accumulation, supplementing retirement income, or funding mortgage or loan repayments. Because of its unique characteristics, cash value accumulation in a life insurance policy may produce more favorable long-term results relative to other financial alternatives.

Life insurance death benefits can be designed as a fixed amount and can be structured to avoid some of the volatility of returns associated with market-driven financial assets. Life insurance can be thought of as an asset class with little to no correlation with other asset classes, subject to the claims paying ability of the insurer. For example, a life insurance policy designed to offer a guaranteed level death benefit can be expected to provide this benefit regardless of economic conditions. A wide variety of product types are available, offering a number of interest crediting mechanisms and fund allocation options that can be designed to match individual risk appetites. In addition, life insurance offers flexibility when the future of tax policy is undetermined. In response to this uncertainty, clients will benefit from planning strategies that provide adaptability and liquidity to respond to a changing tax environment.

Comparison of Savings Vehicles

HNW and HIE taxpayers may take advantage of a variety of tax planning and income deferral techniques. Effective planning likely includes a combination of several strategies including permanent life insurance.

Comparison of Common Planning Techniques for Future Income Needs				
	Qualified Plan	Roth IRA	Traditional IRA	Life Insurance
No Contribution Limits				X
No Deduction Phaseout	X			X
No Income Restriction	X			X
No ERISA Requirements		X	X	X
No Non-Discrimination Testing		X	X	X
No Early Withdrawal Penalty				X
No Required Minimum Distributions		X*		X
Tax-Deferred Accumulation	X		X	X
Tax-Free Distributions		X		X
Tax-Free Death Benefits				X

*Roth IRAs are not subject to RMDs during the lifetime of the owner, but are subject after the owner's death.

Life Insurance in a Rising Tax Environment (continued)

Advantages of Life Insurance

Cash value life insurance provides unique tax characteristics, resulting in a product with unmatched planning flexibility:

- Interest credited to the policy's cash value is generally tax-deferred.³
- Policy cash value can be accessed on a first-in-first-out (FIFO) basis, using policy loans and withdrawals, allowing contributions to be withdrawn first, followed by gains.⁴
- The death benefit can be structured to be received income tax free to beneficiaries pursuant to IRC Sec. 101(a)(1).
- There are no contribution limits (aside from complying with Section 7702 Definition of Life Insurance tests), income restrictions, or deduction phaseouts on life insurance premiums, a solution for HNW and HIE clients that have already contributed the maximum allowable amounts to tax-preferential retirement accounts.
- Life insurance can be funded with earned or unearned income, creating planning opportunities using premium dollars from multiple sources.
- Life insurance can be owned by individuals or corporations, increasing its attractiveness in executive benefit plans and compensation planning for HNW and HIE taxpayers. Businesses of all sizes can utilize the benefits of life insurance, including the tax-deferred cash value growth.

Summary

Due to a unique combination of tax advantages on both the accumulation and distribution of funds within it, cash value life insurance can be a powerful way to reduce income taxes over the long term. In addition, unlike the alternative retirement vehicles noted above, life insurance benefits can be structured to pass to heirs without being subject to income or estate taxes, a feature that is exceptionally attractive to HNW and HIE taxpayers with assets likely to exceed their lifetime needs.

³ Non-MEC policy gains may become taxable upon withdrawal, surrender, or lapse.

⁴ Subject to the rules and regulations of IRC Section 7702; policy withdrawals, loans, and loan interest will reduce policy values and may reduce benefits.

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