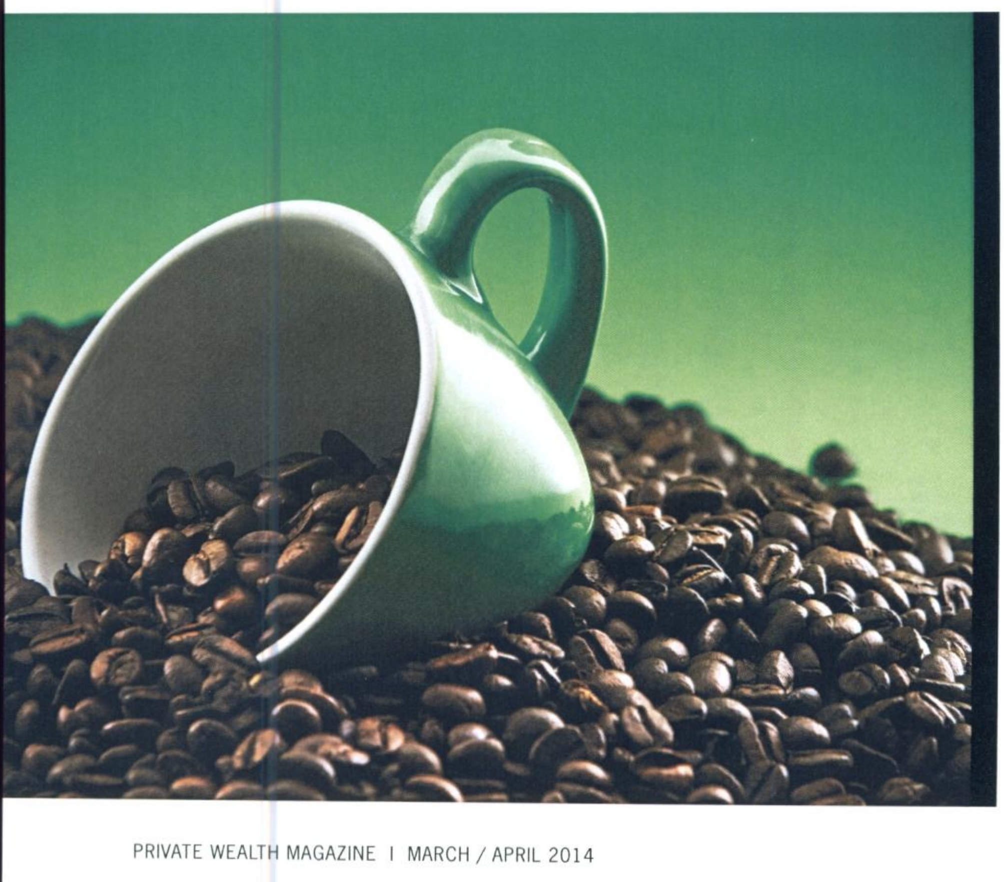
TAX RELIEF THROUGH OVERFUNDING

High-net-worth clients are in a position to reap extra benefits from the overfunding of life insurance policies. BY GARY A. BOROWIEC

THE 2014 TAX SEASON HAS come in like a lion, and many of the CPAs we work with are reeling—not from the normal tax-season workload, but from the number of clients who missed the news about the 2013 tax hikes.

Newsletters were sent. Tax planning was completed. And yet nothing seems to have adequately prepared affluent taxpayers for hefty tax increases of 27% to 66%. Whether you're a financial advisor or a CPA, one thing you can do to make next year's tax season a little more bearable for high-net-worth clients is to introduce them to the benefits of overfunded life insurance.



While the primary purpose of life insurance is providing a death benefit to the policyholder's beneficiaries, paying more premium than necessary to drive up cash value can transform a life insurance policy into an alternative investment vehicle that offers tax-free growth and an income-tax-free death benefit. It is a particularly strong choice at a time when high market volatility has become the norm and more tax increases may be on the horizon.

Unfortunately, permanent life insurance has been portrayed as a less-than-optimal option, with the popular advice being to "buy term and invest the difference." This makes communicating the benefits of overfunding universal life (UL) and indexed universal life (IUL) policies a challenge, but one that can be easily overcome by offering details that are often left out of the cursory discussions typically aimed at middle-income earners, for whom this approach may not be the best option.

For business owners and other high-net-worth investors, IULs offer particularly strong advantages, including the flexibility to invest in index funds with guaranteed asset protection and no management fees. Fixed-rate ULs remain a strong option for highly conservative affluent investors seeking a higher fixed rate of return. For those clients whom you believe would benefit from overfunding permanent life insurance as a component of their overall wealth management plan, the following discussion points may help you clarify the value:

• **Tax-favored growth:** Tax rates on investment portfolios continue to rise, making income-tax-deferred investment options a critical component of retirement planning. Returns on permanent life policies grow untaxed—when properly structured, they may be accessed untaxed, provide an income-tax-free death benefit, and/or continue to grow tax-deferred until funds are drawn (prior to death).

• **Guaranteed annual return:** Both ULs and IULs offset potential portfolio losses in the face of a volatile global market. ULs offer a guaranteed fixed rate of return, while IULs offer a long-term average rate of return between 6% and 8% (net of costs and fees). The cash account of IULs grows at the same rate as the corresponding market index value and continues to earn a minimum interest rate even if the market falls.

• **Asset protection:** In contrast to trusts and other investment vehicles, permanent life policies fully protect principal from any legal claims by creditors. And unlike domestic asset-protection trusts that require the assistance of an attorney and charge an annual asset management fee, they can be structured by a licensed life insurance professional at a much lower cost. In addition, policy principal does not reduce the benefits of government programs such as Social Security and Medicare, which provide supplementary retirement assets and benefits. Death benefits are distributed tax-free, further protecting assets for beneficiaries.

• **Funding flexibility:** Unlike vehicles such as traditional IRAs, Roth IRAs and qualified plans, there are no contribution limits on permanent life policies as long as each policy complies with TEFRA/DEFRA regulations. This makes the option particularly appropriate for affluent investors and small business owners who either don't want to implement a qualified pension plan or who want to save more than the QP permits. If needed, the cash value of the policy may be used to cover premium costs, ensuring death benefits remain intact, and policyholders may adjust the size of the death benefit at any time once the policy is in effect.

• **Penalty-free distribution prior to age 59½:** Permanent life policies offer near-immediate access to assets with no tax penalty. This tax-free liquidity is particularly valuable in the event of a disability, to fund early retirement or to fund personal and business expenditures. Policies can also be structured to offer policyholders the option to buy property, cars and other high-priced assets from themselves while retaining unlimited access to policy principal.

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• **Disability waiver:** Permanent life policies can be structured with a waiver that eliminates payment of premiums and other recurring fees if the policyholder is seriously injured or becomes ill. This option ensures the policy won't lapse, the death benefit is maintained and principal continues to grow even when funds are not available to pay the usual fees.

• **Efficient retirement tool:** Traditional IRAs and qualified plans offer tax-free growth, but are taxable at distribution. In contrast, permanent life policies offer tax-free growth and a tax-free income stream at retirement, providing high-net-worth investors benefits that mirror those of Roth IRAs, but without the income limitations. By balancing tax-deferred and tax-preferred options, investors can ensure a tax-efficient retirement income stream.

Overfunding isn't appropriate for every investor, but it is a valuable option for investors in reasonably good health who are serious about long-term savings on a tax-efficient basis; small business owners who either don't want to implement a qualified pension plan or want to save more than the qualified plan permits; executives who want to save more than their company plan permits and whose company-sponsored 401(k) plan does not offer a Roth option; and anyone who is concerned about future tax rates and finds a tax-free distribution option attractive in retirement.

If you have a client who is interested in overfunding life insurance, it is important that the policy is carefully structured to ensure funding sufficiently exceeds policy costs and to enable efficient growth of the policy cash value. If you don't have detailed knowledge in this area, it is important to work with an independent and licensed life insurance professional (CLU, ChFC or CFP) who understands the complexity and features of permanent life insurance contracts, as well as applicable IRS tax rules (TEFRA and DEFRA). *Rw*

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