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TAX CHANGE WILL BENEFIT LIFE INSURANCE

Although the economy is still engulfed in the coronavirus pandemic, markets have looked forward to better times ahead. The Federal Reserve's swift decision in March to cut its key interest rate to zero and relaunch large-scale asset purchases unmistakably kept the economy from suffering lasting damage. However, such low interest rates are detrimental to life insurance companies, which heavily invest in high-quality bonds to meet their long-term liabilities. When rates tumble, life insurers investment yields follow suit.

Life insurance enjoys some unique tax benefits, including tax-deferred growth of cash values, first in first out (FIFO) distribution of cash values, income tax-free loans and an income tax-free death benefit. Prior to the adoption of federal tax laws in 1984, policyholders could place an unlimited amount of money into a life insurance contract and still reap these tax advantages. Then a certain reality set in that affluent people could house a lot of cash inside a life insurance policy and take advantage of the tax-friendly features. Under IRC Section 7702, there would be new rules that differentiate between genuine life insurance policies and investment vehicles masquerading as them. In general, the rules stated that if someone paid more premium into a policy than necessary to fund its insurance benefit, the contract would fail to meet the definition of life insurance and lose its favorable tax treatment.

At that time, Congress had put an interest-rate floor in place to determine if permanent life insurance policies performed too much like investments. As a result, premiums were deemed to earn no less than 4% in the cash value account for purposes of the Section 7702 test. A small tax change in a year-end spending package lowered the minimum interest rate to 2% this year. This lower rate serves to increase the amount of premium that owners can put in the savings portion of a life policy.

According to a recent article in Wall Street Journal, "the year-end change by Congress will generally increase the amount of money that policyholders can contribute to their so-called cash value accounts…" while the change applies to buyers of all income levels, wealthier people would typically be better able to afford extra payments into a policy."

In view of the increased chance for higher income-tax rates in the coming year, this represents a unique opportunity for high net-worth investors to shield cash value earnings from higher taxes. If you would like to discuss your specific life insurance needs, please contact us.

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