Cash Value Life Insurance in Retirement Planning

Examining the tax outcome of cash value life insurance relative to individual retirement vehicles, such as Roth IRAs.

By Mark Browne

Developing investment and retirement portfolios that are calibrated to one's financial goals is a critical aspect of successful planning. Investors choose among options that cover the gamut of risk- and-return profiles. Many of these options are subject to different rules governing tax treatment. Investments such as mutual funds provide tax advantages like lower capital gains and dividend tax rates. Qualified retirement vehicles, such as SEPs, 401(k)s, and 403(b)s, provide valuable tax advantages as well.

In this paper, I examine popular individual retirement savings accounts, such as IRAs, that enjoy valuable tax advantages and factor heavily in many people's wealth-building strategies, together with cash value life insurance, which is often less understood. Cash value life insurance also provides tax advantages for wealth accumulation—while providing financial protection of one's beneficiaries against the potentially catastrophic consequences of a premature death.

How Cash Value Life Insurance Works

Unlike simple term life insurance—in which a policyholder pays premiums in exchange for the promise of a death benefit payout in the event that the insured person dies during the contract term—cash value life insurance is a hybrid financial product that includes both a death benefit component and an accumulation component. These policies provide cash value growth to offset higher insurance costs to policyholders in later years. Without this offset, policyholders would have to pay these increased costs directly in order to keep a policy in force, when it is most valuable. As insurance needs change or emergencies occur, policy cash values can be borrowed against or withdrawn.[1]

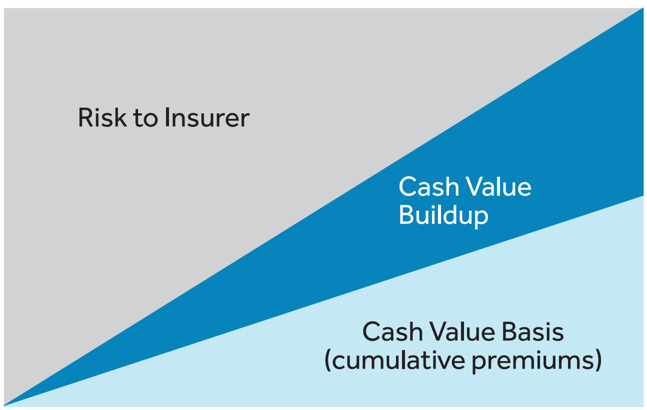
Cash value life insurance policies can be designed to emphasize stability or flexibility. On one end of the spectrum, whole life policies offer stability in the form of fixed premiums and death benefits, as well as a guaranteed rate of cash value growth. On the other end, variable universal life policies offer flexibility in the form of adjustable premium payments[2] and death benefits, as well as a broad range of investment options with different degrees of risk[3] and return.

[1] Depending on the policy form and duration, withdrawals may incur surrender charges. Borrowings or withdrawals will also reduce the amount of death benefit that is paid and the available cash surrender value. Policy loans accrue interest.
[2] Adjustments to premium payments may impact cash value accumulation rates and therefore future out-of-pocket insurance costs (premiums) to the policyholder.
[3] The cash value of a variable life insurance policy is subject to market risk, including a possible loss of principal. Expenses include, for example, mortality and expense risk charges, cost of insurance charges, fund fees, and any applicable surrender charges.

The Basic Tax Advantages of Cash Value Life Insurance

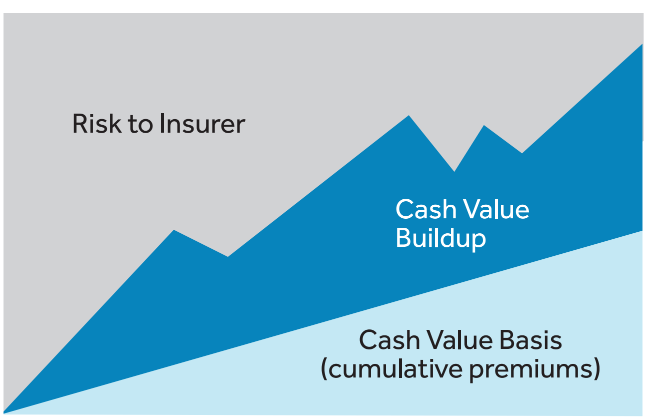
When structured appropriately, cash value life insurance policies enjoy tax advantages in both their death benefit and cash value components. First, for societal reasons that Congress considers important, the death benefit typically passes to the beneficiary tax-free, enhancing the value of the mortality protection.[4] On the cash value side, one of the basic tax advantages of cash value life insurance is that any potential cash value growth occurs on a tax-deferred basis while the policy remains active. Because of this advantage, any "inside buildup" of growth can accumulate more rapidly, particularly for high earners who may prefer to pay higher premiums to maximize that benefit. **Figure 1** below illustrates the cash value buildup inside a typical whole life insurance policy, assuming the policy continues to remain funded and no loans or withdrawals are taken from the policy.

Figure 1: Whole Life Insurance by Components of Cash Value



In the case of variable universal life insurance policies, which offer the opportunity for market participation, the policy's cash value typically fluctuates, as illustrated in **Figure 2**.

Figure 2: Variable Universal Life Insurance by Components of Cash Value



The tax advantages that come with either type of cash value life insurance are preserved under certain conditions* as long as a policy meets the legal definition of life insurance. Since 1984, Section 7702 of the US tax code has defined the tests that are used to make this determination, and these tests effectively limit the amount of cash value a policy may hold relative to its death benefit at any given time.[5] While the model assumptions underlying these tests have gone largely unchanged for decades, recent legislation has modified Section 7702 to use a lower minimum interest assumption in its cash value testing, relative to prior law, in the current interest rate environment.[6] Actuarially, this important revision permits an increase in the amount of cash value per dollar of death benefit that can accumulate in a cash value life insurance policy free of current taxation, an increase that may very well be necessary to ensure that a policy with a certain expected death benefit stays in force

When structured appropriately, cash value life insurance policies enjoy tax advantages in both their death benefit and cash value components.

at later ages, when annual insurance costs are highest. Depending on investment performance and insurance needs, greater tax-advantaged wealth accumulation may now be possible through cash value life insurance for individuals who prefer to maximize the investment value of their policies relative to the amount of pure life insurance they are buying.

Cash Value Life Insurance in Retirement Planning

Tax-advantaged vehicles that facilitate wealth accumulation differ in a variety of ways, including in their (1) tax treatment of funds when invested, (2) tax treatment of investment earnings on the amounts invested, and (3) the imposition of taxes on amounts when withdrawn. To maximize wealth accumulation to meet lifetime goals, all need to be considered and tailored to an individual's particular circumstances.

Roth IRAs offer valuable tax advantages but are subject to income and contribution restrictions that limit the extent to which they can be used for wealth accumulation. For example, a single filer who earns more than $144,000 in modified adjusted gross income in 2022 cannot contribute to a Roth IRA, while a married couple filing jointly is similarly disqualified with income above $214,000. Even for those not affected by income restrictions, the maximum individual contribution to a Roth IRA is only $6,000 per year ($7,000 per year for people over 50). Accessing cash value in a life insurance policy involves more contingencies than accessing cash in a Roth IRA, because

[4] Additional tax considerations may apply, for example, for individuals with large estates, for employer-owned policies, or for policies sold on the secondary market.
[5] For example, a healthy 20-year-old could not hold $90,000 in cash value in a life insurance policy with a $100,000 face amount, because the investment component would dominate the life insurance component.
[6] 26 US Code Section 7702(f)(11).
* For details, refer to the disclosure on the final page.

cash value life insurance is not subject to income or contribution limits. But it merits special attention for those whose who have life insurance needs and whose income disqualifies them from contributing to a Roth IRA—as well as for those who have maxed out their allowable Roth IRA contributions and want to direct additional funds toward tax-advantaged growth.[7]

The difference in tax treatment of funds at the time they are contributed to a traditional IRA versus those paid into a Roth IRA is illustrative. Contributions to a traditional IRA are commonly made with pretax dollars. Since pretax funds are paid into a traditional IRA, when these funds are later withdrawn, they are taxed at the individual's prevailing tax rate at the time of withdrawal. The buildup in interest is also taxed upon withdrawal. Also, a withdrawal may be subject to penalty taxes if withdrawals occur before age 59½. In contrast, with a Roth IRA the money contributed is in after-tax dollars. Upon withdrawal, the money that was contributed is not subject to taxation. Moreover, for qualified withdrawals from Roth IRAs (generally, those made after reaching age 59½), the investment return is also tax free. Significantly, funds within both a traditional IRA and a Roth IRA grow tax free until they are withdrawn, thus providing an important tax shelter for investment growth.

When choosing between a traditional IRA and a Roth IRA, one needs to consider the tax rate that would apply to a contribution today and what that rate might be in the future when withdrawals are made. Tax rates in the future can vary and will likely depend on your annual level of taxable income at the time of withdrawal.

Money contributed today to a Roth IRA is subject to current tax rates. The direct contributions that are subject to income taxes before being contributed to the Roth IRA are not subject to taxation again. Individuals in the top tax bracket need to consider whether they are better off paying today's 37% federal marginal rate on invested funds or a possibly different rate in the future when their direct contributions are withdrawn. The top marginal tax rate was a relatively low 28% for the tax years 1988 through 1990. The rate was 92% in the tax years 1952 and 1953. One's degree of risk aversion and expectations regarding future tax rates should be carefully considered when deciding between a traditional IRA and a Roth IRA.

Contributions to a traditional IRA, in contrast, if made with pretax dollars, are subject to taxation when withdrawn. The tax rate at that future point in time might be lower or higher than 37%. For individuals facing higher tax rates during retirement than during their working years, the tax rate on the contributed funds will be higher than they would be otherwise. But the opportunity to earn investment income on the funds that would have been paid in taxes at the point of funding can offset having to pay the possibly higher tax rate at the point of withdrawal.

An astute wealth builder will recognize that qualifying for cash value life insurance can provide some benefits similar to those of a Roth IRA, if and when insurance needs change in the future so that policy cash values can be used for a purpose other than providing permanent insurance. There are additional costs associated with cash value life insurance that a Roth IRA does not entail, including the administrative costs and cost-of-insurance charges associated with life insurance; however, there is also the important additional benefit of life insurance protection.

Consider how a typical cash value life insurance policy operates. The owner of the policy pays premiums to the life insurer with after-tax dollars at the inception of the contract. The portion of the premium above the insurer's current costs of providing coverage establishes the cash value of the policy. Additional future premium payments provide further incremental contributions to the policy's cash value. Any potential cash value growth occurs free of taxation while the policy is in force. Subject to policy conditions, and assuming insurance needs have changed, the policyholder can withdraw funds from the cash value. If appropriately structured, withdrawals of cash value may not be subject to taxes to the extent of direct premiums paid into the policy; however, it does lower both the available cash surrender value, which could be used to pay future insurance costs if it were left in the policy, and the death benefit payable on the policy.

The primary purpose of a cash value life insurance policy is to provide a death benefit. Similar to a Roth IRA, however, a cash value policy may also provide a means to grow wealth free of taxation. Also, like a Roth IRA, because the premiums funding the policy are made with after-tax dollars, these amounts, if properly structured, may not be subject to income taxes upon withdrawal. For someone concerned with the possibility of facing a higher tax rate on marginal income in the future, the risk of facing a higher tax rate on these funds at the time of withdrawal may be minimized.

In addition to providing life insurance protection, cash value life insurance has an additional benefit that is not available with a Roth IRA: the accumulated cash value in a policy can be borrowed.** Technically, the loan is from the insurer, with the cash value account serving as collateral on the loan. While outstanding loan balances (including accrued interest) lower the death benefit and cash surrender value, interest may continue to accumulate on the loaned amount since the loan does not decrease the cash value of the policy. Also, importantly, accessing cash through policy loans is not treated as a taxable event, as long as the policy stays in force. Policy loans, therefore, offer an opportunity to access investment earnings without generating a tax bill. Properly implemented, such a strategy may be able to mimic the signature Roth IRA benefit of tax-free access to investment earnings.

In conclusion

Because of its tax advantages, cash value life insurance merits an important place in the discussion of wealth accumulation strategies, alongside other tax-advantaged vehicles such as traditional IRAs and Roth IRAs. While it is a different type of financial vehicle, cash value life insurance shares certain tax advantages with these options. Moreover, through a strategy of high early funding and later cash access to any cash surrender value through withdrawals and loans if the need for life insurance decreases, investors may be able to derive tax advantages from their cash value life insurance policies* akin to those available from Roth IRAs. Naturally, this approach carries with it the additional limits, costs, and benefits associated with owning life insurance; but it also alleviates some of the income and contribution limits that apply to Roth IRAs, and hence may be especially worth considering for individuals who are ineligible to fund a Roth IRA or who have already maxed out their allowable Roth IRA contributions.

[7] While one type of account, a Roth 401(k), allows higher contribution limits than a Roth IRA, some people do not have the option to invest in an employer-sponsored plan.
* For details, refer to the disclosure on the final page.
** For details, refer to the disclosure on the final page.

Mark J. Browne is the chair of the faculty of the School of Risk Management in the Tobin College of Business at St. John's University. Dr. Browne has served as president of the American Risk and Insurance Association, the Risk Theory Society, and the European Group of Risk and Insurance Economists. He has been awarded lifetime membership in the Risk Theory Society. An expert on risk management, insurance, and employee benefits, he teaches courses on these topics and has consulted with businesses on issues related to them. Mr. Browne's research has appeared in many publications, including the *Journal of Risk and Insurance*, the *Journal of Insurance Regulation,* the *Journal of Risk and Uncertainty,* the *Journal of Legal Studies* and the *CPCU Journal.* He is regularly consulted by media and has been quoted in *The Milwaukee Journal Sentinel, The Wall Street Journal,* and *Bloomberg BusinessWeek,* among other publications.

This white paper is funded and provided as a courtesy by New York Life Insurance Company. The author's intent with this paper is to explain concepts, not to represent a particular policy or strategy for a particular client or situation.

Please consider the investment objectives, risks, and charges before investing in variable universal life insurance. The product and fund prospectuses contain this and other important information and can be obtained from your financial professional. Please read the prospectuses carefully before investing.

* When structured properly, variable universal life allows for tax-free income as loans and withdrawals. Loans accrue interest. If earnings are withdrawn, ordinary income taxes and surrender charges may apply. Certain tax advantages are no longer applicable to a life insurance policy if too much money is put into the policy during its first seven years, or during the seven-year period after a "material change" to the policy. If the cumulative premiums paid during the applicable seven-year period at any time exceed the limits imposed under the Internal Revenue Code, the policy becomes a modified endowment contract. A modified endowment contract is still a life insurance policy, and death benefits continue to be tax free, but anytime you take a withdrawal from a modified endowment contract (including a policy loan), the withdrawal is treated as taxable income to the extent there is gain in the policy, and a 10% IRS penalty tax may apply. If you are under age 59½, in addition to regular income taxes, a penalty tax of 10% could be assessed on those amounts upon surrender of the policy. In addition, withdrawals within 15 years after a policy is issued may be taxable to some extent if the death benefit under the policy is also reduced.

** The total outstanding loan balance (which includes accrued loan interest) reduces your policy's available cash surrender value and life insurance benefit. The amount you borrow will accrue interest daily. Any loan interest that you do not pay when due will be added to the policy's outstanding loan principal and will also accrue interest daily. If your policy lapses, or if you surrender it while you have an outstanding policy loan, you may be liable for federal or state income taxes if the gross cash value of your policy (before being used to repay the loan balance) is more than the total amount of premiums you have paid into your policy (less certain nontaxable distributions). New York Life will report any taxable gain to you, the Internal Revenue Service (IRS), and any applicable state taxing authorities. Please be sure to discuss this with your tax advisor.

Neither New York Life Insurance Company (New York, NY) nor its agents provide tax, legal, or accounting advice. Please consult your own professionals before making any decisions.

Guarantees are based on the claims-paying ability of the issuer.

Securities products, such as variable universal life, are offered through registered representatives of NYLIFE Securities LLC (member FINRA, SIPC), a licensed insurance agency, and New York Life Insurance Company.

New York Life Insurance Company

51 Madison Avenue
New York, NY 10010

www.newyorklife.com

AR11180.102022 SMRU1948648 (Exp. 09.01.2024)