Tax Planning With Life Insurance

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A cash value life insurance policy is a product that helps to secure the financial futures of families upon the death of an individual and enjoys a very favorable tax status.

While payments into the policy are generally not tax-deductible (unless the policy is bought within a qualified retirement program), the death proceeds are received by the policy beneficiaries free of income tax[1]. This favorable tax treatment of the policy death benefit reflects the government's acknowledgement that providing financially for one's family is an undertaking that should be encouraged.

In addition, since the typical cash value life insurance policy is funded with equal payments over the lifetime of the insured, amounts paid in excess of the cost of insurance and other expenses in the early years of the policy are allowed to compound on a tax-deferred basis over the life of the policy. This tax-deferred cash value growth may allow the policy to be "pre-funded" at reasonable amounts over the life of the policy, rather than requiring an increasing payment as the insured gets older and has a higher probability of dying – which is the way a typical term policy is structured.

The structure of a whole life insurance policy with level premiums helps to make a lifetime death benefit protection program work efficiently and remain in force until the insured eventually dies and proceeds can be paid to the family to meet its ongoing financial obligations. Were the premium to increase each year, eventually the insured might find the cost of the insurance to be too much of a financial burden and discontinue making premium payments, perhaps leading to the lapse of the policy and loss of the needed insurance protection.

Another attractive feature of a cash value life insurance policy is the ability to take loans against the value of the policy[2] which can be done without current income tax. Proper policy design from inception is critical to having these intended tax advantages, which is why it is important to work with a knowledgeable life insurance professional.

For example, policy loans can be used for a number of purposes over the lifetime of the insured. One typical use of policy loans is to pay for the increasing costs of attending college. The death benefit of the policy also serves as a self-completing feature, were the insured to die prematurely, before the family has the opportunity to accumulate sufficient funds to send the children to college. Life insurance cash values can also serve as a sort of "emergency fund", which can be accessed when life throws the family a financial challenge.

Finally, policy cash values can be accessed income tax-free using policy loans and withdrawals in retirement as a source of supplemental retirement income. Who among us could not use an additional source of retirement income? Of course, accessing policy funds during lifetime will decrease the total death benefit that will be paid out when the insured eventually passes on, and enough cash value must be left in the policy to keep it in-force until the death of the insured. This is another reason why working with an insurance professional is so important.

Many families have come to recognize and appreciate the many tax advantages of cash value life insurance. Structured properly, such a policy can offer both living and death benefits that complement well their other financial strategies.

To determine if the many tax-advantages of cash value life insurance should be a part of your financial strategy, contact a life insurance professional for a thorough review of your particular situation. You may be surprised to find that you have a number of alternatives that may be able to help you and your family pursue greater financial security in these unsettled times.

1.Internal Revenue Code § 101(a)(1). There are some exceptions to this rule. Please consult a qualified tax professional for advice concerning your individual situation.

2.Policy loans and withdrawals reduce the policy's cash value and death benefit and may result in a taxable event. Withdrawals up to the basis paid into the contract and loans thereafter will not create an immediate taxable event, but substantial tax ramifications could result upon contract lapse or surrender. Surrender charges may reduce the policy's cash value in early years.

The views and information contained herein has been prepared independently of the presenting representative. It is presented for informational purposes only, and should not be construed as tax advice. Please consult with a tax professional before acting upon any such information.

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