Life Insurance: It's Not Just for Income Replacement

by Robert Wheeler
Regional Insured Solutions Consultant

INSURANCE & ANNUITIES

This article explores some alternate considerations to leverage life insurance, outside of the traditional approach, for individuals and families with significant wealth.

When most of us think about life insurance, we view it as an income replacement strategy—a means to provide our loved ones with a tax-free, lump sum death benefit to help offset the loss of potential future income, as well as pay off any estate-related debts. For individuals with significant wealth, however, a permanent life insurance policy can also be leveraged to accomplish two other important financial goals:

- For high earners who've maxed out their traditional tax-deferred retirement savings vehicles (e.g., 401k and IRA accounts), it offers an opportunity to gain additional tax deferral.
- A policy can also be purchased and held inside an irrevocable trust to better protect assets for future generations, and to instill some controls on how the assets are used.

Traditional Income Replacement

At its core, life insurance affords your family with protection against a number of potential worst-case scenarios—such as you or your spouse passing away and leaving both significant medical bills, as well as a major hole in the family's income. With an in-force life insurance policy, the financial future of your beneficiaries wouldn't be jeopardized.

For many people, a term life policy will suffice—it's simple and affordable. And it can provide enough money to pay off a mortgage and other debts, cover a child's college expenses, and leave your spouse with a nest egg. Term life offers death benefit coverage for a predetermined time period (typically from 5 to 30 years), but at the end of the term, the policy expires with no residual value or return of premiums.

Conversely, permanent life insurance provides a death benefit for your entire life; as long as premiums are paid to keep the policy in force. Depending on the terms of the coverage, you also may be able to access the accumulated cash value of the policy through withdrawals and loans.

A Source of Additional Tax-Deferred Retirement Income

While the main purpose of life insurance is to provide for your beneficiaries in the case of your death, a permanent life policy can also provide supplemental income during your lifetime. By overfunding (contributing more to the policy than the required annual premium), you have an opportunity to accumulate significant cash value on a tax-deferred basis. You can then access this cash value in the future (through withdrawals and loans) to generate additional tax-advantaged retirement income.[1]

Overfunding can help drive up the policy's cash value—transforming it into an investment vehicle that offers tax-deferred growth, remarkably efficient tax-advantaged income distributions, and an income-tax-free death benefit.

The extra retirement income generated by overfunding may even allow you to delay your Social Security start date to enhance your monthly benefit amount. However, overfunding isn't appropriate for everyone, and it's important to note that federal tax law limits the amount of premium contributions that can be made to a policy in order for it to retain certain tax advantages.

If you're in reasonably good health, have maxed out all your traditional tax-deferred savings opportunities and are looking to put away more, are concerned about future tax rates, and value the idea of tax-free retirement distributions, this could be a strategy you may want to carefully consider.

Tax-Efficient Wealth Transfer

While the Tax Cuts and Jobs Act of 2017 dramatically increased the lifetime gift tax exemption amount ($13,610,000 per individual in 2024), keep in mind that after 2025 that exemption amount is scheduled to revert back to pre- 2018 levels (around $6.6 million adjusted for inflation).

Given this uncertainty, estate taxes could dramatically decrease the amount of wealth you're able to successfully transfer to beneficiaries upon your death. One solution is to place assets in a trust(s) for your heirs. However, high tax rates on trust dividends and income can dramatically slow the growth of those assets.

But did you know there's no federal or state income tax (or Medicare surtax) imposed on the lifetime growth of cash value inside a life insurance policy? A permanent life policy held in a trust can deliver enhanced income and cash value accumulation, along with tax-deferred growth and tax-free income. Unlike other trust assets which may have to be reallocated (triggering capital gains and fees), when used strategically as an asset class, life insurance can provide predictable future value and significant leverage due to the income tax-free guaranteed death benefit—which may be several multiples of the policy premium, depending on your age and risk class.

Irrevocable Life Insurance Trusts (ILITS)

Trusts can be a powerful and flexible part of your estate plan, to help provide for future generations. An Irrevocable Life Insurance Trust (ILIT) can be used to hold a life insurance policy (as the policyholder with an appointed trustee), so when you die, it collects the death benefit (as the policy's beneficiary) and distributes the death benefit to the beneficiaries of the trust, as per your wishes. This can help ensure that your children's and/or grandchildren's financial legacy isn't eaten away by estate taxes, divorce settlements, or lawsuits.

In effect, the trust becomes both owner of the policy and beneficiary of the death benefit proceeds—not only removing those assets from your taxable estate, but leveraging their ultimate value. One of the most tax-efficient ways to pay the annual insurance policy premiums is to use your annual gift tax exclusion (in 2024, $18,000 per year for each trust beneficiary) to fund the trust.

However, there are definitely a few downsides to permanent life insurance—it's considerably more complicated and more expensive than a term life policy. That being said if your primary objective is additional tax deferral and/or efficient wealth transfer rather than income replacement, a permanent life policy may be an appropriate choice.

We're here to help you determine what amount and type of insurance would best meet your planning needs and objectives.

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1. Loans and withdrawals reduce the policy's cash value and death benefit and may have tax consequences.

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