

Tax-Free Income through Life Insurance. Really?

Initially, it **might not seem to make much sense**, but **modern cash-value life insurance can be designed to produce tax-free "income" in the form of loans from the life insurance company to the policy owner, while the life insurance policy itself serves as loan collateral**. When the insured person dies, a portion of the policy's death benefit is used to pay loaned amounts back to the insurance company, and the balance of the death benefit (often substantial) is paid to the policy beneficiary (e.g., a spouse, children or a trust). Conceptually, this is similar to a reverse mortgage on a home.

Indexed Universal Life Insurance (IUL). IUL has been specially designed to be more flexible and more transparent (e.g., regarding costs) and to provide better growth of cash value than other types of cash value life insurance (e.g., "whole life"). **Cash value** is basically the value of the policy account that accumulates after policy costs are paid from premiums. IUL works well to build wealth (with very low risk, as explained below) because its cash value grows tax-free and its death benefit and living benefits are tax-free. (In contrast to cash-value life insurance, term life insurance provides a death benefit but does not accumulate cash value. In other words, the only way to get a benefit from term insurance is to die during the limited time period (term) of the policy.)

Premiums paid for policy benefits; immediate leverage. A typical IUL policy is designed for a certain number of annual premium payments (e.g., over 5 or 10 years). As soon as the policy comes into force, the death benefit is payable upon death of the insured. Living benefits (e.g., for serious, chronic, terminal illness) are also usually available after a year or so. In other words, from day one, premium payments are immediately leveraged up to very large death and/or living benefits. In accordance with the goal of maximizing cash value (and later "income"), however, the death benefit is minimized initially to minimize costs and to maximize the amount of premiums dedicated to growth of the policy's cash value.

IUL for income is a long game (10-15 years plus), but there is Liquidity. For income purposes, IUL makes sense when the owner does not need or want income (i.e., policy loans) for at least about 10-15 years after the policy comes into force. Of course, the death-benefit protection and access to any living-benefits (e.g., serious, chronic, terminal illness) are virtually immediate and remain for the life of the policy. Thus, IUL immediately leverages premium payments to provide substantial, potential benefits in case of premature death and certain illnesses. Furthermore, the cash value of IUL is always liquid, that is, it is available to the policy owner if necessary.

IUL Design. Design of an IUL policy for maximum cash-value growth and maximum income is critical to its long-term viability and its ability to provide income. Design depends on the underlying policy structure and, more importantly, on the choice of policy options. An **optimally designed IUL policy minimizes initial death benefit and thereby maximizes cash-value growth**. Minimizing death benefit decreases policy costs, enhancing cash-value growth and, later, available income. *(To qualify for the favorable tax treatment under IRC §§ 101 and 7702, a policy must provide a certain minimum amount of death benefit. For this reason, term life insurance is often included in the design.)* Unfortunately, many **greedy or ignorant insurance agents** design

policies for maximum death benefit, which results in **increased costs** (including **increased commissions** to agents!), **reduced lifetime income**, and much greater risk of **policy lapse** (which has bad tax consequences).

Low-Risk Cash-Value Growth is linked to one or more market indices, with a 0% Floor. Cash value in an IUL policy is generally "linked" to one or more market indices; for example, to an S&P 500 fund and/or other index funds, but there is no direct investment in the markets. The cash value of a policy account is "credited" periodically at a certain percentage rate based on the growth of the linked fund during a given period (e.g., a 1-year period). For example, if an index fund had a positive rate of return, e.g., 14%, during a 12-month period, then the cash value would be credited at a rate **based on** (but usu. not the same as) the rate of return, e.g., 10%. If the fund had a negative rate of return, however, for example, -15%, the cash value in the policy account would be credited at zero percent, that is, there is a **"0% floor"**. In other words, there is **no direct market risk** and the policy's cash value never goes down solely due to a negative market index. (Cash value can go down in 0% years, however, due to continuing (albeit decreasing) policy costs, which is why it is important to **minimize costs**, as explained below.)

Options budget. How can an insurance company credit cash value at a positive rate when the markets are up, but provide a 0% floor in a downward market? By purchasing options. Essentially, the company invests policy funds in a bond portfolio, which protects principal and also yields known, relatively low, but certain yield (rate of return). The company uses the bond yield ("options budget") to purchase options in one or several market index funds (usually selected by policy owner). If the fund has positive return, the insurance company exercises the options and credits cash value at a corresponding positive rate. If the fund has a negative return, the company allows the options to expire without exercising them, while the bond principal protects the policy cash value, which is credited at zero percent ("0% floor").

Bond Interest Rates and Inflation Protection. A policy's options budget increases as the interest rates paid in the insurer's bond portfolio increase. As an options budget increases, so does the potential for upside growth of cash value. Inflation and bond yields are typically correlated. For example, in years 2022-23, influenced by rising inflation, corporate bond yields have increased. Accordingly, options budgets have increased, resulting in higher potential policy crediting rates. Thus, IUL also provides a hedge against inflation.

Summary of IUL benefits. IUL offers a wide range of benefits:

- an immediately available death benefit (in case of untimely death)
- immediately available living benefit options (e.g., for chronic, serious, terminal illness)
- tax-free market-linked growth, linked to (but not invested in) one or more selected market indices
- risk-free growth of policy value via 0% "floor" (no exposure to negative market returns)
- potential protection against inflation
- tax-free lifetime income (via policy loans paid back with death-benefit proceeds)
- tax-free income protects against risk of rising tax rates

- tax-free income avoids high tax brackets for other, taxable income (e.g., Social Security)
- income-tax-free death benefit
- asset protection (varies by state) during life of insured
- avoidance of all taxes plus asset protection, forever, when owned in a [dynasty trust](#)

Are there risks associated with IUL? Yes, there can be, but **proper policy design effectively minimizes risks**. The most obvious **risk** arises **if policy costs** (e.g., cost of insurance, policy administration fees, agent commissions, rider fees) **outstrip cash-value growth**. If market indices are down over many years (i.e., the crediting rate is 0% in those years), then policy costs could gradually erode the cash value available later for tax-free income and might even cause a policy to lapse unless the policy owner adds additional premium. Recently, some bad players in the life insurance field have designed **risky policies with "crediting bonuses"** to make them look more attractive to clients and thereby increase sales and agent commissions. "Crediting bonuses" multiply a policy's crediting rate by a large factor, but at the cost of **exorbitant "rider fees"** (e.g., 5% of total policy cash value every year!). The crediting bonus is paid only in a positive year, but the high rider fee is subtracted from cash value every single year, no matter what. If 0% is credited to account cash value for numerous consecutive down-market years, then cash value diminishes and a policy could **lapse** (i.e., there is not enough money in the policy account to pay annual costs without additional premiums). Of course, the risks of 0% years are typically not disclosed to unwitting clients, who find out only later, the hard way, that their policies are time bombs. **In contrast, a well-designed IUL policy is robust and is capable of enduring multiple 0% years because policy costs are low.**

IUL "income" is like a reverse mortgage. IUL policy loans for income are similar in many ways to a reverse mortgage on a home. Like all loans, they are received tax-free. When reverse mortgage loans are taken, the residence serves as collateral for the loans. The home itself remains untouched and intact; the home value typically increases over time (except during a real estate crash). When the owner of the residence dies, the house can be sold to pay back the loans and the balance of the house's sale proceeds goes into the owner's estate (or to a family trust). Similarly, with **IUL policy loans, the policy itself serves as collateral**. Tax-free loans from the insurance carrier are secured by the policy's death benefit, but the policy stays intact, providing living benefits and death benefit, if needed, while the policy's cash value continues to earn its periodic credits. As with a reverse mortgage, the borrower need not make any principal or interest payments on the loan. When the insured dies, a portion of the death benefit pays the loans plus loan interest to the insurance company, and the balance of the death benefit goes to the policy's beneficiaries.

Hybrid "premium-financing" to leverage IUL. The analogy to a home can be extended to the purchase of IUL. The more money a home buyer has available, the more house can be bought. Home buyers almost always use a home mortgage to buy a bigger, better house than they could otherwise afford. The house serves as collateral for the mortgage loan. Similarly, with **IUL**, bank loans can be used to pay higher premium amounts and the **IUL policy serves as collateral for the loaned premium payments**. In a well-designed hybrid IUL plan, the policy owner need not

provide any personal collateral or personal guarantees, need not make interest payments, and need not undergo any financial underwriting. By using **leverage to buy a bigger IUL policy with greater cash value, the owner gets greater benefits, that is, more tax-free income, more living benefits, more death benefit.**

IUL, best way to build and protect wealth for you and your family? On balance, IUL is arguably the safest and most reliable longer-term way to build wealth for you and your family. Depending on circumstances, it can even outperform equity investment accounts and qualified money accounts (IRA, 401(k), 403(b)), but without the risk. IUL is substantially insulated (0% floor) against downturns of the marketplace, but it grows tax-free in positive markets. It provides immediate protection against untimely death and illness. Income taken as policy loans is tax-free. There are no RMDs as with qualified retirement plans (e.g., 401(k), 403(b)). Also, there are virtually no maximum contribution limits (IRAs and qualified plans have annual contribution limits). Tax-free death benefits pass directly to beneficiaries. It can be owned in a trust for efficient management and asset protection.

Contact [Shoreview Insurance](#) to **learn more about IUL** and to **do some calculations** based on your (or your client's) particular circumstances.

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