M Financial Group™

LIFE INSURANCE IN A CHANGING TAX ENVIRONMENT

Advisors and high-net-worth individuals with federal estate tax exposure have long relied upon life insurance as a sophisticated planning tool. Life insurance offers a unique combination of liquidity, leverage, and flexibility, with the ability to fund future obligations.

As effective income tax rates continue to increase and allowable deductions decrease, the unique features of life insurance are becoming increasingly appealing. Life insurance is purchased with after-tax dollars, and the gain on inside buildup is not taxed when held within the contract, consistent with treatment of appreciation on stock or home values.[1]

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[1] AALU: Life Insurance Provides Financial Security & Peace of Mind (2014)

High-net-worth taxpayers will likely benefit from a review of planning strategies that allow for income-tax-deferred growth, including life insurance. High-income earners, those with earned income extending into the top tax brackets, can also benefit from life insurance as part of their overall financial portfolio.

THE INCREASING INCOME TAX ENVIRONMENT

Both high-net-worth and high-income taxpayers have been subject to substantial income tax increases in recent years. The 2017 Tax Cuts and Jobs Act made extensive changes to many parts of the federal tax code. The top tax bracket was adjusted to 37%, the standard exemption roughly doubled, and many above-the-line and itemized deductions were limited or discontinued.

Perhaps of most significance to high-income taxpayers, the State and Local Tax deduction was limited to $10,000. This limitation, which effectively causes double taxation on previously deductible income used to pay sales, property, and state income taxes, has a significant impact on the actual tax bill paid by high-income earners and high-net-worth individuals.

Tax changes are also occurring at the state level, in many cases resulting in marginal tax rates exceeding 50%. High-net-worth and high-income taxpayers will be increasingly motivated to consider the tax efficiency of different asset classes and will likely favor deferral strategies that shift income and tax payment into the future, where they may anticipate being in a lower tax bracket.

THE CASE FOR LIFE INSURANCE

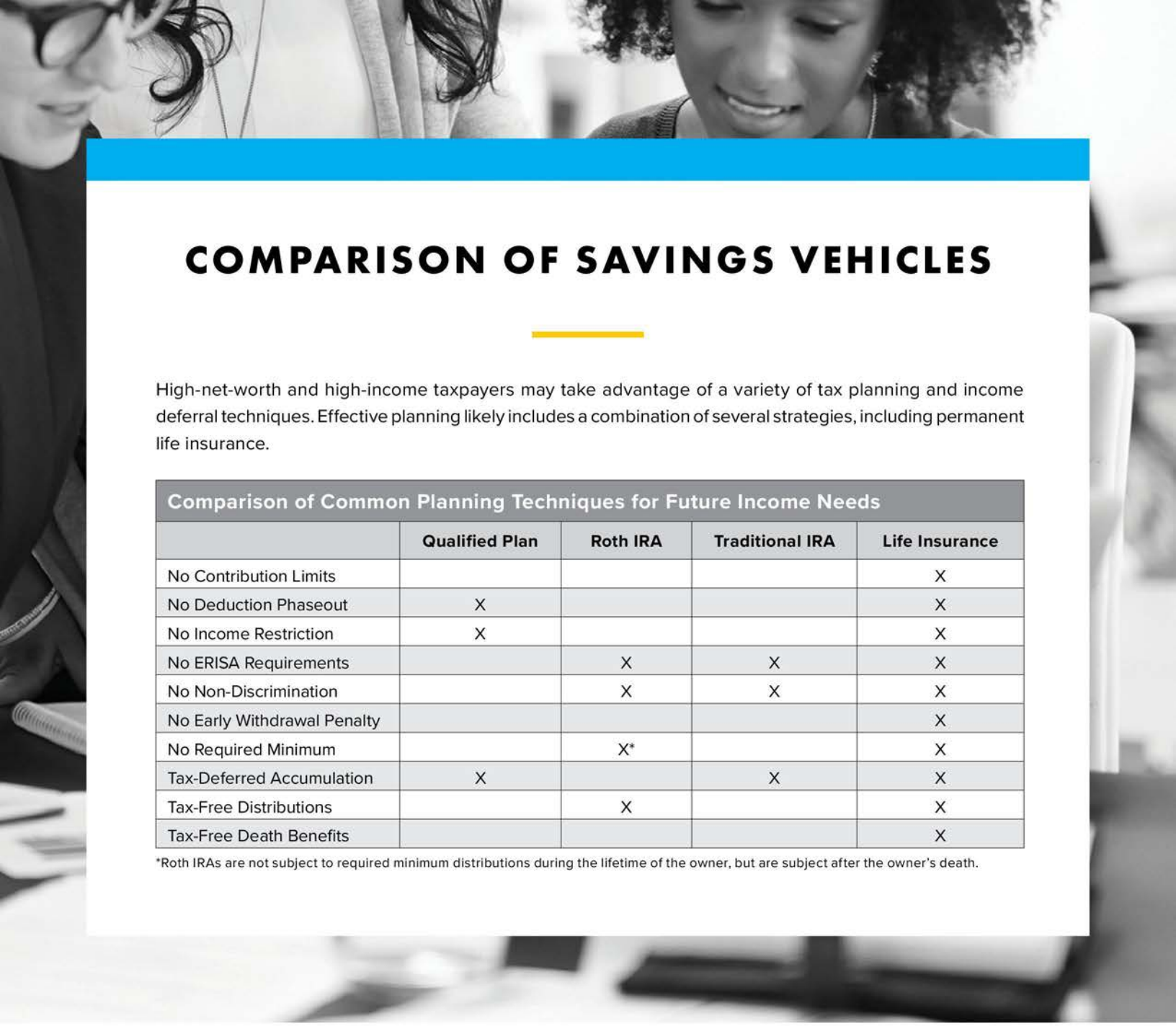
Advisors frequently view life insurance as a way to mitigate the financial consequences of untimely death. As such, life insurance is often designed to minimize premium cost, measuring success based upon the policy's internal rate of return at the insured's life expectancy. While this is a valuable measure of a policy's effectiveness, cash accumulation features within permanent policies can build significant value during lifetime for high-net-worth and high-income taxpayers and should also be considered in the context of life insurance and financial planning.

These living benefits may help achieve a wide range of financial objectives, including cash accumulation, supplementing retirement income, and funding mortgage or loan repayments. Because of its unique characteristics, cash value accumulation in a life insurance policy may produce more favorable long-term results than other financial alternatives.

Life insurance death benefits can be designed as a fixed amount and can be structured to avoid some of the volatility of returns associated with market-driven financial assets. Life insurance can be thought of as an asset class with little to no correlation with other asset classes, subject to the claims-paying ability of the insurer.

For example, a life insurance policy designed to offer a guaranteed level death benefit can be expected to provide this benefit regardless of economic conditions. A wide variety of product types are available, offering a number of interest-crediting mechanisms and fund allocation options that can be designed to match individual risk appetites.

In addition, life insurance offers flexibility when the future of tax policy is undetermined. In response to this uncertainty, clients will benefit from planning strategies that provide adaptability and liquidity to respond to a changing tax environment.



COMPARISON OF SAVINGS VEHICLES

High-net-worth and high-income taxpayers may take advantage of a variety of tax planning and income deferral techniques. Effective planning likely includes a combination of several strategies, including permanent life insurance.

Comparison of Common Planning Techniques for Future Income Needs				
	Qualified Plan	**Roth IRA**	**Traditional IRA**	**Life Insurance**
No Contribution Limits				X
No Deduction Phaseout	X			X
No Income Restriction	X			X
No ERISA Requirements		X	X	X
No Non-Discrimination		X	X	X
No Early Withdrawal Penalty				X
No Required Minimum		X*		X
Tax-Deferred Accumulation	X		X	X
Tax-Free Distributions		X		X
Tax-Free Death Benefits				X

*Roth IRAs are not subject to required minimum distributions during the lifetime of the owner, but are subject after the owner's death.

ADVANTAGES OF LIFE INSURANCE

Cash value life insurance provides unique tax characteristics, resulting in a product with unmatched planning flexibility:

- Interest credited to the policy's cash value is generally tax-deferred.[2]
- Policy cash value can be accessed on a first-in-first-out (FIFO) basis using policy loans and withdrawals, allowing contributions to be withdrawn first, followed by gains.[3]
- The death benefit can be structured to be received income-tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1).

[2] Non-MEC policy gains may become taxable upon withdrawal, surrender, or lapse.

[3] Subject to the rules and regulations of IRC Section 7702; policy withdrawals, loans, and loan interest will reduce policy values and may reduce benefits.

- Life insurance can be funded with earned or unearned income, creating planning opportunities using premium dollars from multiple sources.
- Life insurance can be owned by individuals or corporations, increasing its attractiveness in executive benefit plans and compensation planning for high-net-worth and high-income taxpayers. Businesses of all sizes can utilize the benefits of life insurance, including the tax-deferred cash value growth.

SUMMARY

Due to a unique combination of tax advantages on both the accumulation and distribution of funds within it, cash value life insurance can be a powerful way to reduce income taxes over the long term. In addition, unlike the alternative retirement vehicles noted above, life insurance benefits can be structured to pass to heirs without being subject to income or estate taxes, a feature that is exceptionally attractive to high-net-worth and high-income taxpayers with assets likely to exceed their lifetime needs.

This information has been taken from sources we believe to be reliable, but there is no guarantee as to its accuracy. This material is not intended to present an opinion on legal or tax matters. Please consult with your attorney or tax advisor, as applicable.

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