Life insurance already provides tax advantages, but some insurance products push the envelope in search for more. Recent developments, though, bode ill for these schemes.

Be Wary of Products Marketed Mainly for Tax-Advantaged Status

By Peter Katt

April, the tax month, reminds us of the overwhelming impact our tax system has on investment and life insurance decisions. I'm not prepared to say this is an entirely bad thing, since every rule in the tax code is the natural result of the disorderly process a free society uses to govern itself.

Regarding the tax implications of life insurance—with the exception of employer-sponsored group term life insurance of $50,000 or less and life insurance owned by a qualified plan—life insurance premiums are an aftertax cost (i.e., not deductible), permanent life insurance (whole, universal, and variable life) cash values accumulate tax-deferred, cash value withdrawals are tax-free until they exceed the policy's basis, and death benefits are entirely income-tax-free.

Tax-deferred cash value build-up and income-tax-free death benefits provide life insurance with substantial tax advantages. Unfortunately, some life insurance companies and their salesmen aren't satisfied with these simple and real advantages. Instead, great effort is made to twist an already complicated tax code into even more awkward configurations in search of tax-deductible premiums and living benefits that are entirely income-tax-free. In recent months, the IRS has hammered one plan promising such tax nirvana and dealt another a potentially fatal blow.

This column will inventory various life insurance designs marketed for their supposed tax-advantaged status.

Leveraged Life Insurance

Leveraged life insurance promises tax-deductible funding and tax-deferred accumulation without the constraints of a qualified pension or profit-sharing plan. Apparently there are several versions of leveraged life insurance that have been peddled. Most of the plans use some form of split-dollar. The presentation of the various plans is breathtakingly complicated. The flow chart for it has arrows going in every direction. It is sold to professionals (primarily physicians and dentists) doing business as corporations. The essential ingredient is the creation of a possibly questionable "loan" between the professional's corporation and the insurance company. There is no actual money exchanged, although various bookkeeping entries are made. This so-called "policy loan" carries a very high loan interest rate, say, 15%. The interest cost on this is tax-deductible to the corporation, causing a large part of what is paid to the life insurance company to be tax-deductible. Thus, by some sleight of hand, the insurance company is able to characterize a major portion of the actual premium as tax-deductible loan interest.

It should be noted that regular corporations (not S corporations) can deduct loan interest for loans up to $50,000 per employee, but the loan must be legitimate. There is no strict definition of a "legitimate loan," but in my opinion the policy must have loan value of at least the amount borrowed to be considered a legitimate loan. For this reason leveraged life insurance has been very controversial.

There is a saying in the investment and life insurance worlds that "pigs get fat and hogs get slaughtered." The leveraged life insurance hog has been slaughtered. Late last year the Tax Court (Young v. Commissioner, TC Memo 1995-379) ruled against this particular plan's tax-deductible scheme. In so doing, the Tax Court also added injury to insult by not only denying the tax deduction, but ruling that the amount thought to have been deductible is in fact a dividend to the shareholder insured, meaning the amount was non-deductible to the corporation and taxable to the insured.

Equity Split-Dollar Life Insurance

Equity split-dollar refers to a life insurance plan in which an employee (who could be a shareholder of the corporation) or a trust owns a life insurance policy insuring the employee, but with the premiums paid by the corporation employer. In exchange for paying the entire premiums, the corporation re-

Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance adviser located in Mattawan, Michigan (616/372-3497). His book, "The Life Insurance Fiasco: How to Avoid It," is available through the author.

ceives a collateral assignment guaranteeing it will receive the exact amount of its cumulative payments at the death of the insured employee, surrender of the policy, or termination of the split-dollar arrangement. In essence, the employee receives an interest-free loan. The presumed advantages for the employee are that in the event of his death his family would receive the death benefits, less the collateralized amount tax-free and the insured employee has access to the policy's equity (cash value in excess of the amount owed back to the corporation) to withdraw or borrow. For example, an equity split-dollar plan for a 35-year-old male might have annual premiums of $12,000 paid by his employer for a $500,000 universal life policy. After 10 years the employee would have projected equity of about $20,000 (cash value less the cumulative premiums paid by the corporation) and a net death benefit to his family of about $520,000. After 20 years there would be net equity of about $160,000 and a net death benefit of $660,000. The presumed cost of this program to the employee, until the split-dollar arrangement is terminated, is the taxes paid on the value of the life insurance coverage this plan provides. That is, if the cost of $500,000 of term life insurance were $1,000, this is the amount the employee would include in income and pay taxes on. If the employee was in a combined marginal tax bracket of 35%, his cost for the equity split-dollar plan that year would be $350.

This plan has been a favorite of life insurance salesmen selling various non-qualified employee benefits to employers. However, a nagging question about the tax consequences to the insured employee of the policy's increasing net equity has just been given a limited answer by the IRS. In a technical advice memorandum (TAM 9604001) this year ,the IRS has ruled that the employee must include in his income the value of the insurance protection (which has always been the case) *plus* the net equity build-up in the policy. Including the equity build-up in the employee's taxable income each year is a new interpretation and is sending shock waves through the life insurance industry. For example, if the net equity increase in a given year is $6,000, the insured employee would include this amount in his income, plus the value of the insurance protection, and pay taxes on the sum of these two items. A technical advice memorandum only applies to the situation addressed in that particular memorandum, and cannot be cited as precedent, but this is a definite signal from the IRS regarding how it presently views the tax status of equity split-dollar. This memorandum is of great significance not only for future equity split-dollar plans, but also for equity split-dollar plans currently in existence. If this memorandum position is widely adopted by the IRS, the rationale for equity split-dollar will end. My professional view of all split-dollar life insurance has always been that it is mostly a sales gimmick. With this memorandum casting its dark cloud, only the most aggressive life insurance companies and salesmen will continue to recommend it. (Please refer to my April 1994 *AAII Journal* column that explains split-dollar plans in detail).

Funding Qualified Plans

In general, life insurance can be used as partial funding of a qualified pension or profit-sharing plan. It has been touted by the life insurance industry because contributions to the plan are tax-deductible, and therefore the portion that pays the life insurance premium is also deductible. A tax-deductible life insurance premium is very appealing to most professionals and business owners unless the full ramifications of having a qualified plan own life insurance are considered. My comments to follow refer to businesses, including professional corporations, in which the insured is the business owner:

- Pension and profit-sharing plans have become indescribably (at least for this columnist) complicated, making the installation of a qualified plan much less desirable for business owners. If there is no qualified plan, there is no need to worry about putting life insurance in it. The complicated rules have reduced significantly the number of life insurance companies that market life insurance for qualified plans;
- For qualified plans funded with life insurance, the annual cost of term protection is included in the insured's income, making the annual cost to the insured the taxes paid on the this term cost;
- If the insured dies while the policy is in the plan, the cash value portion of the death benefits (less the insured's cost basis, which is the cumulative value of term costs) are taxable to his family. This wouldn't be the case if the life insurance were owned by the insured directly. Therefore, I conclude that if the insured dies while covered by the qualified plan his family would be better off with his life insurance owned personally, not by the qualified plan;
- Plan contributions that go to cash value life insurance instead of a traditional investment vehicle will be worth much less at retirement because of the additional costs associated with a life insurance policy;
- At retirement, the life insurance must either be cashed-in, thereby eliminating the family protection element, or it may be maintained by taking the policy as a distribution, paying taxes on the cash value, less the insured's basis. Taking it as a distribution at retirement can cause the premature payment of taxes on funds that the insured may wish to maintain as tax-deferred for some additional time in a rollover IRA.

If all of the many elements involved in having life insurance in a pension or profit sharing plan versus having the same policy owned personally by the insured are taken into account, business owners are better off owning their life insurance personally by a margin of 25% to 35%. My calculations tracked all of the elements affecting life insurance in a qualified plan versus owing it personally, using identical assumptions for both and assuming in retirement that the life insurance has either been terminated (producing a 25% advantage for having owned life insurance personally) or continued for the life of the insured (producing a 35% advantage for having owned the life insurance

personally).

Since there are significantly fewer qualified plans being installed by small businesses (especially professional corporations), the most important issue regarding life insurance and qualified plans may be considering what to do about life insurance policies previously purchased and currently funding plans. I suspect in most every case where a business owner is insured with a policy owned by his qualified plan, he will be better off if a new low-load policy (Ameritas or USAA) is purchased outside the qualified plan to replace the policy in the plan. Be sure no life insurance is terminated until the new policy is in force. Also, be aware that if a new policy is purchased to replace a policy in a qualified plan, there is a new two-year period in which the policy can be contested and a two-year period in which a claim won't be paid if death is by suicide.

The Private Pension Plan

Because most life insurance companies have ceased marketing qualified plans funded with life insurance, some have turned to something they call the *private pension plan*. Unlike qualified plans funded with life insurance, the private pension plan's premiums are not deductible; nevertheless, they are touted to have these benefits: income-tax-free investment build-up prior to retirement; income-tax-free income during retirement; and income-tax-free asset transfer to heirs. In fact, while life insurance salesmen try to make this sound like a new idea, it isn't anything more than life insurance. Life insurance cash values do grow tax-deferred, policy loans aren't taxable under current law, and the death benefits are income-tax-free. The gimmick is the claim that *all* of the retirement benefits from the policy will be from policy loans with no loan interest being charged. There are two problems with this claim. First, Congress didn't intend for life insurance to be used in this fashion. This is an unintended loophole that could be closed any time Congress wishes (and Congress certainly knows about it). Second, many life insurance actuaries are skeptical about the legitimacy of making interest-free loans on such a massive scale as thousands of insureds who were sold these plans reach retirement. If policy pricing in the presence of massive interest-free loans were to become unstable, changing the terms of these plans is an option of the company. Not only can the cost of insurance and policy earnings (or dividends) be weakened due to massive borrowing, but the promise of no loan interest isn't guaranteed and loan interest could be imposed at any time. If these things were to occur, or if the policy inadvertently terminated, causing all of the gain to be taxable even though there would be no further cash available, these private pension plans could blow up. It is of significance that some of the finest life insurance companies, such as Northwestern Mutual and Guardian, don't offer such plans. They not only charge market interest rates for borrowed cash values, but they also reduce dividends on policies that have policy loans. (Please refer to my August 1992 *AAII Journal* insurance column, "Two 'New' Investments: Life Insurance Repackaged," for a more complete discussion of private pension plans).

Using life insurance for the dual purposes of providing family protection and for its tax-deferred accumulation is something I support in the right circumstances. Indeed, I have written about this five times in past columns. However, your decision should not be made on the assumption that you will receive income-tax-free retirement income via zero interest policy loans. Rather, I prefer to simulate a plan in which policy withdrawals are tax-free until they exceed cost basis, then taxable. If using life insurance for its dual function as a tax-deferred accumulation vehicle makes sense under this more cautious assumption, then it is a good strategy. If at the time it appears that it is safe to characterize the income from the policy as loans with no loan interest, then by all means take advantage of this, but don't assume it will be a reality.

Conclusion

Life insurance has significant tax advantages without pushing the envelope. When considering the tax implications associated with life insurance, take a conservative approach so you don't buy life insurance for the wrong reasons, only to find out that the promised tax advantage is a mirage.

Remember that personal life insurance premiums are not deductible, cash values grow tax-deferred, withdrawals up to basis are tax-free, and death benefits are income-tax-free.

Claims that go beyond these should be discounted or ignored.