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Winged Keel Group Insights

Unlocking the Value of Cost Basis in Unlikely Places

Winged Keel Group Insights is a publication designed to create education and awareness around life insurance topics and solutions that may address certain needs of your clients and their multidisciplinary goals.

By Marko Djuranovic and Barbara Novak

When it comes to evaluating existing life insurance policies that have outlived their original intent, policyowners and their professional advisors are often stuck in stasis, a condition of inactivity where no financial decision seems to be particularly compelling.

The standard options[1] are well-known to experienced advisors and their clients:

SURRENDER THE POLICY: If the policy has cash surrender value, the policyowner can invest the proceeds elsewhere after paying the income taxes (at Ordinary rates) on the gain portion of the policy (the difference between the policy's cash surrender value and cost basis, which is usually the sum of premiums paid).

KEEP THE POLICY: Depending on the insured's overall health and financial means to maintain the coverage, the policyowner may continue to pay the premiums or reduce the policy's insurance benefit so that no further premiums are required.

RESTRUCTURE THE POLICY: Depending on the insured's overall health and financial means to maintain the coverage, the policyowner may continue to pay the premiums or reduce the policy's insurance benefit so that no further premiums are required.

SELL THE POLICY: For some older insureds with the right health profile, the life settlement market can provide the policyowner with a materially higher value than merely surrendering the policy, even net of fees and taxes.

In many situations, the answer is obvious. For high cash value policies, with minimal taxable gain, where the policyowner has access to investments that often have superior rates of return, surrendering the policy may be the prudent solution. For guaranteed policies with little or no cash value and guaranteed future premiums that are priced well below market, keeping the policy likely makes the most sense. And for older insureds with a checkered medical history who lack the funds or inclination to maintain the policy, a life settlement may be the best fit. Finally, for policies with significant cash value a tax-free IRC Section 1035 Exchange to new coverage with a guaranteed and/or higher death benefit makes sense.

But outside of these clear-cut situations, the optimal path forward is less obvious. In this article we suggest looking to the policy's cost basis to unlock options not considered previously or shed new light on existing options. We consider situations where the policy's cost basis differs materially (it is higher or lower) from its cash surrender value.

[1] While an Internal Revenue Code Section 1035 Exchange is also a common option, it is excluded from this discussion based on the premise that the client no longer needs any insurance coverage.

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Cost Basis Less Than the Current Cash Surrender Value

This is a common state with non-guaranteed policies that were adequately funded with premiums at inception and have been inforce for longer than ten years, such as Whole Life, Universal Life, Indexed Universal Life, and Variable Universal Life. On face value, the forward-looking IRR on these policies (measured as the return on the current cash surrender plus any future premiums at the life expectancy of the insureds) may not seem impressive. However, taking into consideration the cost basis and the subsequent tax would be due upon policy surrender can often shift the conversation toward keeping the policy inforce.

Consider the following example: a healthy 70-year-old male owns a Current Assumption Universal Life policy with a $2 million insurance benefit, $1 million of cash surrender value, and $500,000 of cost basis. Assume the insured is in good health and has a life expectancy of 20 years. Assume further that based on the current dividend interest rate, the policy is illustrated to require no further premiums to maintain the insurance benefit until the insured's age 100. Considering solely the $1 million of cash surrender value, the IRR at life expectancy is about 3.7%. However, if the policyowner is in the highest tax bracket and lives in a state with high income taxes such as New York or California, the appropriate IRR calculation should take into account the *after-tax* surrender value proceeds. Assuming a 50% tax rate – as insurance policy gains are taxed at ordinary income tax rates if the policy is surrendered – the policyowner would net $750,000 from surrender of the policy ($1 million minus $500,000 cost basis, multiplied by 50%). Recalculating the IRR on *this* amount suggests that the policy actually produces a forward-looking after-tax IRR of 5.3%. While this is only one factor to consider when deciding whether to retain the life insurance policy, taking cost basis into consideration can produce a meaningful difference in the perceived economics of the policy.

For those wishing to get more granular, there is another option to utilize. Life insurance policies structured as Non-Modified Endowment Contracts ("Non-MECs") enjoy FIFO (First In, First Out) taxation, so one method for further optimizing the policy in the example above would be to withdraw the cost basis ($500,000) without incurring ordinary income tax and invest these proceeds outside the policy. Assuming a proportional reduction in the life insurance benefit from $2 million to $1 million, the after-tax IRR on the remaining $500,000 of cash value in the policy – which would now be all taxable gain if the policy were surrendered or allowed to lapse and net only $250,000 to policyowner – rises to about 7.6%.

In Summary: Taking cost basis into account in this example allows the policyowner to: 1) withdraw some cash tax-free, and 2) more than double the policy's original rate of return on the cash values remaining within the policy.

Cost Basis More Than the Current Cash Surrender Value

This is an even more interesting aspect of utilizing cost basis. All too often, policyowners fail to realize substantial value from their policy's cost basis. Consider a situation that is the reverse of our previous example, so that the 70-year-old male has a $2 million life insurance policy with $500,000 of cash value and cost basis of $1 million. If the policy were surrendered, there would be no gain on the proceeds… and the $500,000 of cost basis in excess of the cash surrender value would be lost.

What could be done with that excess cost basis instead? Here are some options:

LEAVE THE CASH IN THE POLICY: Depending on the rate at which the policy's cash value grows, the cash-on-cash return within the life insurance policy may be superior to what the policyowner can achieve outside the policy on an after-tax basis. Remember, the next $500,000 of cash value accumulation in this policy is tax-free. To further increase the policy's cash value accumulation, the life insurance benefit could be reduced to the Non-MEC limit to reduce the cost of insurance charges. If the policyowner is sure that they will withdraw cash value from the policy as soon it equals the cost basis, it may be appropriate to reduce the policy benefit to its minimum allowable amount (and thereby reduce

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ongoing charges) and even allow policy to become a Modified Endowment Contract (MEC).

COMPLETE AN INTERNAL REVENUE CODE ("IRC") SECTION 1035 EXCHANGE TO A VARIABLE ANNUITY: Transferring the $500,000 of cash value to a Variable Annuity with sufficiently low costs (such as a PPVA for qualified purchasers) would shield the next $500,000 in appreciation from income taxes, save for the ongoing fees assessed within the annuity. The switch from FIFO to LIFO (last in, first out) taxation incurred by switching from a life insurance policy to an annuity would not matter until the $500,000 "tax shield" is exhausted and the Variable Annuity's value increases past the $1 million cost basis. Once that happens, the policyowner can surrender the annuity and deploy the cash elsewhere.

WITHDRAW MOST OF THE CASH VALUE FROM THE POLICY AND THEN TRANSFER THE REMAINING CASH, ALONG WITH SUBSTANTIAL REMAINING COST BASIS, TO A VARIABLE ANNUITY: The advantage of this approach is that the Variable Annuity could be funded with assets at a future time. If the insured/annuitant is particularly young, this approach preserves the cost basis "tax shield" for future use while still allowing the policyowner access to cash surrender value, without incurring any tax. A word of caution though: it is important to allow for sufficient time between the withdrawal of cost basis and the 1035 Exchange, so as not to trigger the "boot" issue with removing assets from a policy shortly before its replacement.

Finally, the policy's cost basis can also come into play when evaluating life settlement offers (which is quite robust now). As an example, years ago we evaluated a potential life settlement offer on a policy with only nominal cash value but a multi-million-dollar cost basis. Due to insured's good health and relatively young age, the life settlement offer was a small fraction of the policy's cost basis. The client and professional advisers determined the immediate cash that would be received from the life settlement was worth less than the "cost basis tax shield" – tax savings that could be realized over the lifetime of the insured if the cost basis were transferred to a Variable Annuity (and the Variable Annuity was funded with additional cash).

Conclusion

Many policyowners and advisors ignore cost basis at their own detriment. This article has shown that a policy's cost basis is an economic asset which can carry meaningful value for policyowners, especially for those in highest tax brackets who reside in high income-tax jurisdictions. While there is no single answer to what should be done with a life insurance policy that has outlived its usefulness and each client's situation is likely to have its own nuances, cost basis should be considered in most portfolio reviews and policy evaluations.

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Disclosures

The above examples are for informational purposes only and are not intended to represent or guarantee that anyone will achieve the same or similar results. Variable annuities are long-term investments designed for retirement. The value of the investment options will fluctuate and, when redeemed, may be worth more or less than the original cost. Withdrawals and other distributions of taxable amounts, including death benefit payments, will be subject to ordinary income tax. If withdrawals and other distributions are taken prior to age 59 1/2 a 10% federal penalty may apply. A withdrawal charge may also apply. Withdrawals will reduce the value of the death benefit and any optional benefits.

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