Taxes: Another Shoe Will Always Drop

by Judith A. Hasenauer | 02-07-2013

Will Rogers said that "the difference between death and taxes is that death doesn't get worse every time Congress meets." Since Congress is in almost perpetual session, taxes can only get worse--even death taxes!

We have written in the past about how hard is it for financial advisors to have any certainty in the advice they give to their clients. Nothing ever seems to be settled when it comes to the necessity for long-range financial planning. Yet, we cannot sit still waiting for certainty; we have to advise our clients and plan for our own futures.

American business is said to be sitting on the sidelines with billions of dollars in cash, waiting to invest when there is a greater degree of certainty than we have had for the past decade. It is also reported that many affluent individuals are also waiting to invest until there is greater certainty about Obamacare, government cutbacks, threatened future tax increases, and a weak recovery from the recession that started over five years ago.

The very affluent have a particularly flexible tool for growing their assets on a tax-effective basis in cash value life insurance. Moreover, virtually all cash value life insurance policies have provisions that permit the exchange of a life insurance product for an annuity that will guarantee income that cannot be outlived. Such a life insurance policy provides for protection against premature death while affording tax-free or tax-deferred investment growth. A properly designed life insurance policy also provides tax-effective liquidity for unforeseen financial needs by utilizing the loan provisions contained in virtually all cash value life insurance products.

Once upon a time it was considered to be a bad investment for affluent people to purchase annuities because distributions from annuities are taxed at ordinary income tax rates. Today, it's worth rethinking that rule of thumb, since even the affluent have cause to worry about outliving their assets unless they have insurance against living too long. And the only insurance against living too long is a life contingency annuity.

Moreover, with capital gains tax rates increasing and possibly going even higher in the future, the ability to time the onset of annuity distributions can have tax advantages. Thus, one can see many benefits in the purchase of a cash value life insurance policy with the contingency for making a tax-free exchange into an annuity when future events make such an action advisable.

It has long been possible to have a tax-free exchange of a life insurance policy for an annuity. Unfortunately, the Internal Revenue Code does not permit the reverse without triggering a taxable event. Variable life insurance policies provide a great deal of investment flexibility to purchasers. Most variable life insurance products have a wide variety of underlying investments, ranging from very conservative to very speculative. Variable life insurance and variable annuities also have a degree of tax-effective flexibility that we do not believe is possessed by any other financial product--the ability to change underlying investments without any taxable gain on the investments that are transferred. Direct investments in mutual funds or hedge funds almost always result in a taxable event when one investment is liquidated and another is purchased. Variable insurance products avoid this tax pitfall.

Tax-free exchanges of one insurance product for another allow the owners of such products to change insurers when events make such actions advisable. Likewise, as newer, more competitive products come to market, the owner of an insurance product can always have the best product in her portfolio. In addition, the rules on partial exchanges of insurance products have become more liberal in recent years, which allow owners of such products an even greater degree of flexibility in their planning for future events.

Another consideration is the federal estate tax, which seems to be with us for the foreseeable future. This means affluent people with relatively illiquid assets, such as a family business or investment real estate, will have a pronounced need for liquidity planning upon death. Life insurance, particularly life insurance that has been the subject of estate planning, can provide the necessary liquidity to avoid fire sales of assets to meet estate and inheritance tax needs. Availability of large sums of cash on short notice in the event of death is a facet of most good estate plans. Such cash can usually only be assured by the existence of life insurance.

By now it should be obvious that the recent tax reconciliation was just one shoe dropping. The other shoe is on its way to the floor; it is just a matter of time until it hits! And after that occurs, we shouldn't be surprised to find additional shoes coming down. The inherent flexibility of insurance products--both life and annuities--can provide valuable protection from whatever form the dropping shoes take. We can protect ourselves and our clients by the judicious use of these products so that the shoe does not drop on us or our precious clients.