

CASE OF THE QUARTER  
CASE # 8  
Taxwise Disposition of Old Life Insurance

**Facts**

A couple in their late 50's contracted with our firm to do a Comprehensive Financial Plan on their behalf. During the fact gathering we were brought into some interesting issues regarding some Life Insurance policies they had purchased in 1985. They had been spending \$1,000 a year for the past 23 years or a total of \$23,000. When they purchased the policies they were shown illustrations assuming interest rates would always be in the 10% or greater range. Based on 10% the policies looked good and would have had no problems at this point. Unfortunately interest rates have dropped and today they are receiving 4% on their cash values. This has caused their principal to be consumed with "mortality costs" and the total cash value in their two policies is now about \$3,000.

**Problem**

So what should they do today? They are both insurable so new policies are likely a better buy than trying to fix the old. The old were based on 1981 Mortality Tables while the new are based on 2001... mortality rates have decreased a bunch so new will be better. But what should be done with the two old policies? They've paid \$23,000 for these policies and they are only worth \$3,000 now and will be worth nothing in 7-8 years.

**Recommendations**

**Strategy #1:** Cancel the policies now and use the \$3,000 to pay for the new insurance or in some other investment.

**Strategy #2:** Do a tax favored Section 1035 transfer of the existing cost basis to the new policy they were purchasing. Their new policy would then have a cost basis of \$23,000 plus new premiums but what benefit would this create? If their goal is to eventually collect a death benefit on the new policies the death benefit is free of income tax anyway so a cost basis means nothing from a tax view.

**Strategy #3:** They could transfer their cost basis to an annuity and then:

**Option #1:** Hold the annuity until its value equals \$23,000 and report zero taxable gain.

**Option #2:** Hold the annuity for a year or two and change their mind. When they cash out the annuity they can likely take an ordinary tax loss for \$20,000+ dollars.

**Bottom Line:**

Through the implementation of Strategy #3 we have allowed a client to have \$20,000 of tax benefits that would have been lost under the most common strategies which are #1 and #2. Assuming the 20% tax bracket this means \$4,000 in tax savings, if 30% it means \$6,000 in tax savings and if 40% it means \$8,000. In our clients' situation they will save between \$6,000 and \$8,000. Our fees for the entire financial plan ran about \$1,600. This one idea more than paid our fees and many other ideas were also implemented.

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