

## A little-publicized tax code could help save you money

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Most individuals are unaware of a little-known tax code that's available to all investors regardless of their income or net worth.

The internal code section for this tax break is IRC 7702. One of its components refers to the tax-advantaged growth of the cash value inside of a life insurance policy. If properly structured, an individual has the opportunity to both grow their investment money and access their money (before or after age 59½) without ever paying taxes on the gains.

However, the IRS puts limits on contributions to life insurance policies because it realizes the tax benefits of the contracts.

So how can you take advantage of tax code 7702?

The code section discusses the fact that as part of a permanent life insurance contract, the cash value grows without tax (whether it's whole life, universal life or variable life). In all such contracts, the insured pays a premium. Part of that premium pays for the death benefits associated with the contract and the rest is invested into the cash value of the policy.

Depending on the policy type, that cash value may be invested conservatively by the insurance company, or it may be invested in a variety of sub-accounts, from stock accounts to bond accounts (similar to choices offered in a 401(k) plan).

In addition to the basic premium required by the contract, additional dollars may be deposited; all would be attributed to the cash value (the investment portion of the contract). There are IRS limits to the amount that can be added (based on age and amount of insurance) because Congress is aware of the tax-advantaged nature of the product. However, these limits tend to be much greater than the base premium.

For example, the premium for \$500,000 of variable life insurance on a 40-year-old male (healthy nonsmoker) is \$5,000 a year. Without violating the tax code, that same individual could invest an additional \$17,000 in the contract (\$22,000 total) -- all of which is attributed to the investment side of the contract.

Those dollars grow without tax under 7702. This maximum amount of \$22,000 can be invested every year, regardless of age, income or net worth.

The specifics of taking money out of the contract tax-free are as follows:

Since after-tax money is used to pay the premiums, the first dollars that are pulled from the contract are tax-free because they're considered to be return-of-premium money. Subsequently, the appreciation in the cash value (the portion exceeding the basis) may be accessed by taking a loan from the policy.

Different types of contracts have a variety of loan charges -- typically as high as 8 percent. Many of the newer-generation contracts, however, offer something called "wash loans," which means that the net cost to borrow money is effectively 0 percent. These favorable loan provisions can be attractive when compared to regular taxable investments, in which investors typically pay either capital gains tax at 15 percent or ordinary income tax at a maximum rate of 35 percent, plus Colorado state tax.

Who takes advantage of this code?

The typical profile of individuals who use insurance as an investment are ones who are maximizing their 401(k)s or IRAs, not eligible for Roth IRAs because of income limits and are looking for places to invest money where they won't be subject to additional taxation.

Open up any Fortune 500 prospectus to the executive compensation section and you'll often find references to "split dollar policies" or "deferred compensation plans" -- both of which usually use life insurance as the funding vehicle.

For investors investigating the use of 7702, look for the following characteristics in a policy in order to maximize your investment: Start with a highly rated life insurance company and look for a contract with low internal costs, a number of investment options and competitive loan provisions.

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