

NicheAlert

The Role of Life Insurance in an Asset Location Strategy

Asset Allocation has been part of the investment professional's asset management strategy for decades. More recently, a considerable amount of attention has been focused on a natural extension of that approach: Asset Location.

Fidelity goes so far as to outline the tax treatment of various assets as part of their effort to educate their clients as seen in Figure 1.

You will likely notice one very important omission in both of those articles and Figure 1: Both Fidelity and Investopedia have neglected an asset class that should play a large role in the Asset Location conversation: Cash Value Life Insurance. This omission is not just common, it's nearly universal. The asset management community largely has no idea how life insurance fits in this approach they have already embraced and are using with their clients.

We've known for years that life insurance's unique value proposition positions it as an analog to things like Roth IRAs that have the following characteristics regarding taxation:

Tax-free: Will be invested after tax, but you will not pay taxes on any distributions from these assets.

Of course, life insurance has a significant advantage: The income-based limitations that can prevent clients from utilizing Roth IRAs don't exist for life insurance.

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While the two terms are extremely similar, their meaning is quite different:

- **Asset Allocation:** The selection of a diversified portfolio of stocks, bonds, cash and alternatives aligned with an investor's time horizon and risk tolerance.
- **Asset Location:** The placement of assets in taxable, tax-deferred and tax-free accounts with the goal of minimizing taxes

Where is Asset Location Being Talked About?

A quick Google search uncovers any number of hits from asset managers and the like, but if we look at where most consumers may ultimately go for information on a topic like this once they are exposed to it, two sources stand out:

- Investopedia: [Minimize Taxes With Asset Location](#)
- Fidelity: [Are you invested in the right kind of accounts? See how tax-smart asset location can potentially help improve after-tax returns.](#)

Figure 1

	Tax Treatment of Expected Returns	Taxable	Tax-Deferred	Tax-Exempt
Municipal securities & municipal mutual funds	Generally Exempt			
Equity securities held long-term for growth	Taxed at long-term capital gain rates			
Equity index-funds/ETFs (other than REITs)				
Tax-managed mutual funds				
Real estate investment trusts (REITs)	Generally, 80% of income taxed at ordinary rates; 20% tax-exempt			
High-turnover stock mutual funds that deliver effectively all returns as short-term capital gains	Taxed at ordinary income rates			
Fully taxable bonds and bond funds (i.e., corporates)				
<div><div> More Appropriate</div><div> Appropriate</div><div> Less Appropriate</div></div>				

For illustrative purposes only. Relocating tax-inefficient assets from a taxable to a tax-advantaged account will be a taxable event and those tax consequences need to be factored into the asset relocation decisions.

If we investigate the account types that fall into the tax-free category further, as seen in Figure 2, the advantages of life insurance over alternatives becomes even more clear:

Figure 2

Each tax-free account has different benefits

There are four main types of financial accounts that produce tax-free income: municipal bonds, tax-exempt, Roth IRAs, fixed life insurance and variable universal life insurance. Each has different benefits to consider. Which one(s) could help you achieve your retirement goals?

Each tax-free account has different benefits				
	Tax-free municipal bonds	Roth IRA	Fixed life insurance	Variable universal life insurance
Fixed investment options	✓	✓	✓	✓
Equity investment options		✓		✓
Free from income contribution limits	✓		✓	✓
Income tax-free death benefit			✓	✓
<div><div><div>Tax-free municipal bonds</div><div>Fixed returns with no contribution limits. You'll typically get a low return and have no equity exposure.</div></div><div><div>Roth IRA</div><div>Fixed and equity investments, with income-based contribution limits. Not available for those filing jointly earning more than \$205,000.</div></div><div><div>Fixed life insurance</div><div>Fixed returns with no income-based contribution limits.</div></div><div><div>Variable universal life insurance</div><div>Fixed and equity investments with no income-based contribution limits.</div></div></div>				

What's the Bottom Line?

In short, positioning cash value life insurance as a tax-free asset in an asset location strategy is an ideal way to introduce the investment community to life insurance. It places life insurance in a context they are already comfortable with and solves a challenge they face in terms of income-based limitations and the like that can prevent their clients from utilizing more traditional tax-free assets that offer market returns.

Next Steps

Educating both current and prospective advisors on this topic is an obvious next step. Accomplishing that requires not only building awareness of the role life insurance can play in this strategy, but also how to actually go about implementing it with a real client.

READY TO PUT US TO WORK ON YOUR NEXT CASE?

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