The ABCs of using cash value life insurance for a child's higher education

A versatile asset to include as part of a college savings strategy

Allison Anne Hoyt, JD, CLU®
Technical Director, Advanced Consulting Group

The birth of a child is oftentimes the life event that prompts new parents to seriously consider their life insurance needs. And not very soon after the birth of a child, an additional financial concern often follows suit: Saving for college.

It's no secret that the costs of higher education stretch the budgets of even the most well-prepared families. New parents have a multitude of options to choose from when it comes to saving for their child's higher education including Coverdell education savings accounts and qualified tuition plans ("529 plans"). However, parents should not overlook the opportunity to use a cash value life insurance policy as part of their child's college funding strategy. If an unexpected death occurs, all or part of the death benefit can be put towards higher education expenses. Further, monies from the policy can be accessed tax free and used to help pay for the costs of a college education.

FUNDING THE POLICY AND USING THE CASH VALUE

A steady as you go, annual funding plan, beginning when a child is a toddler or earlier is ideal. The sooner a parent begins funding the policy, the better it will perform when it is time to access the cash value to fund higher education.

There are two schools of thought as to how to use the cash value in the policy to fund a college education. Some people advocate using the cash values in lieu of loans. However, a more efficient strategy uses the cash value to repay loans that parents have taken out for their child's education and begins that repayment when the child has graduated from college. Leaving the cash value undisturbed for those additional four years or so can significantly improve the policy's performance and the amount of cash that can be safely taken out of the policy.

Let's look at an example: John, Jane and Baby Bailey

John and Jane are doting parents to their three-year-old Bailey. They both attended a private college and believe there is a good chance Bailey will do the same. Bailey's undergraduate education could run into the six figures. John and Jane know they have to start planning, today.

As part of Bailey's college planning strategy, they decide to take out a cash value life insurance policy insuring Jane. Given their current budget, they can contribute $5,000 annually towards the policy and plan on funding the policy for the next 15 years, right up to when Bailey will likely go away to college.[1]

<u>Option 1:</u>

John and Jane decide to use the cash value from the policy to help offset the cost of Bailey's college education, each year she is in school (policy years 16-19).

Option 2:

Instead of taking cash out of the policy the years Bailey goes to college, John and Jane plan on taking out private loans or federal PLUS loans for parents.[2] They allow the policy to continue to grow while Bailey is in college – key growth years that will support their repayment strategy. They instead decide to use the cash value from the policy to help repay the loans they took out to fund Bailey's education, over a standard repayment period of 10 years (policy years 20-29).

Fast forward to Bailey's college graduation

If John and Jane pursued Option 1 they would have been able to access up to $26,748 from the policy each year Bailey was in school, for a total of $106,992. If John and Jane had pursued Option 1, and decided to insure Bailey, they would have been able to access up to $27,468 from the policy each year Bailey was in school, for a total of $109,872 – only $2,880 more than if they had insured Jane.

If John and Jane pursued Option 2, and decided to insure Jane, by waiting four years to access the cash value, and by stretching their payments over 10 years, they can access an additional $60,528 from the life insurance policy's cash value, allowing them to pay $16,752 per year, for 10 years (a total of $167,520). (Almost $100,000 more than they put into the policy.) If John and Jane pursued Option 2, and decided to insure Bailey, $16,776 per year $167,760 ($8)

If you're wondering whether it would have made more sense to insure Bailey, the answer is probably not. Not only is the additional cash from the policy negligible (+$2,880 using Option 1; + $8 using Option 2), by not insuring Jane we lose the potential of a death benefit to help offset the costs of Bailey's college education (> $200,000 of death benefit by age 45).

EDUCATION FUNDING ALTERNATIVES

A cash value life insurance policy is an excellent complement to a child's education funding strategy. When compared to other vehicles used to save for education, a cash value life insurance policy does not have any artificially low limits on contributions, enjoys tax deferred growth of account values, can provide income-tax free distributions and an income-tax free death benefit, and does not count as a resource on the Free Application for Federal Student Aid (FAFSA).

Parents should definitely take another look at this unique asset and the positive role that it can play in financing a child's higher education.

	Cash Value Life Insurance	**529 Education Savings Plan[3]**	**Coverdell Education Savings Account**
Annual contribution limit	None	None. However, there is a maximum cumulative contribution amount that varies by state[4]	$2,000[5]
Gift tax implication of contributions	None if the owner or owner's spouse is the premium payor	Contributions are taxable gifts Can make up to 5x the annual exclusion from gift tax in a single year and have it applied, pro rata, for five years without any gift tax consequences ($80,000 individual; $160,000 married).	None if the owner or owner's spouse makes the contribution
Tax deductible contributions	No	Possible at the state level; varies by state	No
Tax free growth of account	Yes	Yes	Yes
Taxation of distributions	Withdrawals up to investment in the contract and loans are income-tax free (non-MEC) May be used for any purpose	Distributions for tuition, mandatory fees, room and board (i.e. "qualified higher education expenses") are income-tax free If distributions are not used for these purposes, earnings are subject to income tax in addition to a 10% penalty tax, unless an exception to the penalty tax applies	Distributions for tuition, mandatory fees, room and board (i.e. "qualified higher education expenses") are income-tax free If distributions are not used for these purposes, earnings are subject to income tax in addition to a 10% penalty tax, unless an exception to the penalty tax applies
Death benefit	Yes	No	No
FAFSA impact[6]	Not counted as a resource	Max. 5.64% of account counted as a resource	Max. 5.64% of account counted as a resource

This material is not a recommendation to buy or sell a financial product or to adopt an investment strategy. Investors should discuss their specific situation with their financial professional.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives give legal or tax advice.

Nationwide, the Nationwide N and Eagle and Nationwide is on your side are service marks of Nationwide Mutual Insurance Company.
© 2021 Nationwide

NFM-20100AO.1 (03/22)

---

[1] PLUS loans can be borrowed by parents of dependent undergraduate students up to the cost of attendance; there is no requirement to demonstrate financial need. The borrower must not have an adverse credit history. Alternatively, parents may obtain a private loan if they satisfy the requirements of the lender.

[2] 33-year-old female, Preferred Plus NT, Nationwide New Heights IUL Accumulator, 6.00% rate of return (100% allocation to 1-Yr. NYSE Zebra Edge, $5,000 annual premium paid for 15 years, optimal switch minimum non-MEC death benefit. Non-guaranteed values. Illustration available upon request from your Nationwide Life wholesaler.

[3] The other kind of 529 plan is a prepaid tuition plan.

[4] For example, $520,000 in New York; $517,000 in Ohio. $300,000 in Connecticut.

[5] Full $2,000 contribution only available if contributor's modified adjusted gross income is below $110,000 (single) or $220,000 (married). Contributions cannot be made after the beneficiary reaches age 18 unless the beneficiary has special needs.

[6] Assuming owner is parent of dependent undergraduate student.