

## Return-of-Premium Guarantees

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Recently, I wrote about the explosion of financial options and guarantees that has given rise to unprecedented consumer choice. From teaser rates, to put options, to interest rate floors, to insurance policy riders, financial “engineering” is everywhere. I previously argued that to the extent the financial industry is able to engineer some type of financial option that has some visceral appeal to the consuming public, the option will generally be offered only if its terms can be structured to favor its *sponsor*. The more difficult a given financial option is for the consuming public to analyze, the easier it is for the sponsor to tilt the economics of the deal in its own favor.

Here, I’ll address the so-called return-of-premium guarantees that are increasingly being pitched by life insurance companies. The life insurer’s pitch might sound something like this: “Instead of paying \$100 per month towards a term life insurance policy that might expire worthless if you’re still alive at the end of the policy period, simply give us an additional \$100 per month and if you’re still alive when the insurance policy expires, we’ll refund 100% of your premiums – totally tax-free!” Such offers often go so far as to suggest some return-on-investment figure that is temptingly high. – and still tax-free.

Return-of-premium guarantees certainly do have visceral appeal. After all, the only thing better than getting your life insurance for nothing is to have the deal come with a juicy tax-free return. And, since offers like this are becoming ubiquitous, they must be profitable to their sponsors. So, where’s the catch? There are at least two.

First, if you die while the policy is in force, the insurer keeps 100% of those extra premium payments resulting in 100% profit for the insurer...and a 100% loss for you. Therefore, the allure of getting something for nothing must be balanced by the risk of getting nothing for all those extra premium payments.

Second, return-of-premium payments are generally tax-free for the same reason tax refunds are tax-free – because they’re both considered to be a return *of* one’s investment rather than a return *on*

one's investment. Next time, we'll look at other forms of financial fairy dust.

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