Return Of Premium Is Not A Free Lunch

Many insurance companies and their agents will sometimes offer you a life, disability, or other insurance policy with a return of premium (ROP) rider. The salesmanship really kicks in as they explain how wonderful it is. “It’s like getting your insurance for free!” they say. Well, there are precious few free lunches in the world, and this isn’t one of them.

How It Works

Consider a return of premium feature in a disability insurance policy. You’ll pay more for the policy than you otherwise would. Instead of paying perhaps $4000 a year, you’d pay $5000 a year. After 30 years of payments, if you don’t have any disability claims, you get your money back- a check for $5000*30= $150,000.

Catch # 1 – Inflation

Of course, $150K in 30 years isn’t exactly worth $150K now. In fact, assuming 3% inflation, $5K in 30 years will only be worth $2060 today. Obviously the effects of inflation on premiums paid in the 2nd or 3rd decade of the policy wouldn’t be as dramatic, but it becomes pretty clear that you’re really only getting a partial return of your premiums paid. To make things worse, YOU’RE the one running all of the inflation risk. If inflation is 8% instead of 3%, well, the insurance company isn’t going to give you any extra money.

Catch # 2 – Opportunity Cost

There’s also the little matter that you have to pay more for this feature. What if you just invested that extra $1000 a year into a portfolio that returned 9% a year over those 30 years? How much would that be worth? $148,575. Would you consider that "free insurance?" Of course not.

Catch # 3 – It's Either/Or, Not Both

You either get the return of premium, or you get disability payments. If you end up disabled at some point during your career, you don't get that return of your premiums. You just overpaid for your disability insurance. Studies I've seen estimate that disability may happen to as many as 1/7 doctors, so those extra premiums that aren't reimbursed are not insignificant.

Catch # 4 – The Contract Is Written By The Insurance Company

The contract may not even be as favorable as I've stated above. David Richards suggests that it is much more typical for the insurance company to reimburse 50-80% (not 100%) of the premiums paid, less any amounts paid out to you as disability payments and to charge 50% more (not 25% more as in my example above) in premiums in order to reimburse part of your premiums after 5-10 years. He estimates it only takes 4 months of receiving disability claims to wipe out any return of premium you may get. In some ways, you're paying someone else but still self-insuring your own disability, at least for a few months.

Catch # 5 – Return of Premium May Be Taxable

Most disability insurance premiums are not tax deductible, so the return of the premium isn't taxable. But if you are able to take a tax deduction for the premiums, such as a C Corp owner or if you're buying an overhead expense policy, then after ten years that return of premium will be fully taxable.

Catch # 6 – Other Policy Features May Not Be As Strong

If you would otherwise have bought a Standard or Guardian policy, but are now considering a more inferior policy because of the ROP feature, then you may be doing yourself a disservice. In the end, you buy insurance for the insurance aspect, so you want to make sure you're at least getting top-notch insurance. Mixing investing and insurance is usually a bad idea.

Business Overhead Insurance (BOI) – One Time ROP May Make Sense

Since ROP BOI is a tax-deductible business expense, and because the returned premiums, if returned in less than 10 years are also tax-free, it can be a good idea to use this as a tax-shelter, asset-protection shelter, and investment, as long as the numbers make sense. Since the money is at the insurance company, it can't be taken in a lawsuit. Let's assume the premiums without ROP were $5K per year and with ROP were $7500 per year, and 80% of them get refunded after 10 years. Assume a 40% marginal tax rate. Aside from the asset protection benefit, what kind of a "return" will you get on this policy? $7500*10*80% = $60K. If you didn't pay that $2500 extra into premiums, it would be taxed at 40%, so you'd be left with $1500. $1500 invested in a taxable account at 9% a year, minus 23.8% for capital gains taxes, comes out to almost $19K. In order to get $60K instead of $19K, you'd have to have an investment return of about 29% a year! Most of that return, of course, is as a result of the tax arbitrage, turning taxable money into tax-free money. This is all dependent, of course, on you not having a claim. But you can see why a smart doc might be willing to run that risk (or even not make a claim if it is likely to be a short term one.)