

#11: Borrowing from Permanent Life Insurance Policies

Borrowing from permanent (cash value) life insurance policies can assist in bracket management. Selected loans can be used to shift income from years when a taxpayer is in a higher tax bracket to years when the taxpayer is in a lower tax bracket. A permanent life insurance policy is required because it accrues cash value; the cash surrender value is what is being borrowed against. Thus, the borrowing cannot exceed the amount of the cash surrender value. Furthermore, under the policy, interest is earned on the cash surrender value.

This strategy involves paying into the life insurance policy in high income years, perhaps using other assets that would have produced taxable income, and avoiding the higher tax brackets and net investment income tax (NIIT). Then in later years, if taxpayers need additional income, they can increase their available funds, without selling taxable assets and pushing themselves into a higher tax bracket, by borrowing funds from the life insurance policy instead.

However, borrowing against the cash surrender value can affect the life insurance policy in several different ways. First, the death benefit on a variable life policy is reduced by the amount of the loan; it does, however, increase as the loan is repaid. Second, future premiums on a level death benefit policy may be increased to offset and compensate the insurance company for the loss of expected cash accumulation. Finally, the insurer can charge the taxpayer interest on the loan, which is not actually paid but added to the amount of the outstanding loan. Note that the cost of borrowing may be higher than the stated interest rate on the loan. When a policy holder borrows, the insurance company often reduces the interest rate earned on the policy's cash value. If so, this interest rate reduction should be added to the stated interest rate on the loan to arrive at the true cost. The interest accrued on the policy loan is not deductible by the taxpayer, further increasing the cost of borrowing.³⁷

While it is not required that a policyholder repay the loan, in the event the policy is terminated or the policyholder dies, the amount of the life insurance policy proceeds can be reduced by any outstanding principal of the loan as well as any interest that has accrued on the loan.

Generally, when a taxpayer borrows against a life insurance policy, the loan proceeds are not taxable. An exception to this general rule is if the policy is a modified endowment contract (MEC). A MEC is a life insurance policy, purchased after June 20, 1988, where the accumulated premiums paid at any time during the first seven years exceed the sum of the net level premiums for a policy that would be paid up after seven years. A loan from a MEC is treated as a distribution from the policy, and thus is subject to the income-out-first rule. In other words, as amounts are distributed, they are treated as consisting of taxable income to the extent that they do not exceed the excess of cash surrender value of the policy over the investment in the MEC, i.e., premiums paid less tax-free distributions. Additionally, the taxable income will be subject to a 10% penalty tax unless the distribution is made after age 59½, on account of disability, or as part of a series of substantially equal periodic payments.³⁸

³⁷ See Pond, Personal Financial Planning Handbook at ¶ 5.03.

³⁸ IRC §§ 72(e)(1)(A) and 7702A.

Example 1. Taxpayer has a MEC with a cash surrender value of \$100,000. Taxpayer has paid premiums totaling \$25,000. Taxpayer decides to take a policy loan of \$80,000. The first \$75,000 of the loan is taxable income to the taxpayer immediately (\$100,000 cash surrender value - \$25,000 total premiums paid, i.e., investment in the contract).

However, an outstanding loan will generally be treated as an amount received if the policy later lapses or is surrendered; thus, possibly resulting in taxable income. A policy can lapse if the taxpayer fails to make premium payments and, as a result, the policy benefits are exhausted and the policy terminates. An example of this happening is noted above – the amount borrowed plus interest equals or exceeds the cash surrender value and the taxpayer fails to pay-in additional amounts of life insurance premiums.

Additionally, a taxpayer can surrender a policy to the insurer in return for the cash surrender value (minus any amount of outstanding loan plus interest). If the taxpayer surrenders his or her policy or the policy lapses, any gain realized is taxable at the taxpayer's ordinary income tax rate. The gain is equal to the excess of the amount the taxpayer received over the net premium cost. The amount received is the amount the taxpayer got when the policy was surrendered or terminated plus any outstanding loan. The net premium cost, or basis, is the total premiums paid by the taxpayer minus tax-free distributions received. Therefore, if a policy is surrendered or lapses, ensure that the taxpayer is in a lower tax bracket year so the amount received is recognized at a lower tax rate – i.e., the taxpayer took out the loan tax-free during a higher tax bracket year, five years later the policy is surrendered when the taxpayer is in a lower tax bracket year, in which year the taxpayer must now recognize the amount received above basis but at a lower tax rate.

Example 2. Taxpayer has a life insurance policy with a cash surrender value of \$100,000. He has paid total premiums of \$50,000. He also has an outstanding policy loan of \$50,000. There have been no distributions from the policy. Taxpayer decides to surrender the policy to the insurer for \$50,000 cash. Therefore, the taxpayer will have taxable ordinary income of \$50,000 (\$50,000 cash + \$50,000 loan - \$50,000 premiums paid).

Example 3. Taxpayer has a life insurance policy with a cash surrender value of \$100,000. He has paid premiums of \$50,000. He also has an outstanding policy loan of \$100,000. There have been no distributions from the policy. The policy lapses because the amount borrowed equals the amount of the cash surrender value. Therefore, the taxpayer will have taxable ordinary income of \$50,000 (\$100,000 loan - \$50,000 premiums paid).

If the life insurance policy is used effectively, taxpayers will purchase the policy when they are in a high tax bracket year and then borrow from it when they are in a low tax bracket year and need the extra income.

Example 4. Taxpayer (T), filing single, expects to have \$200,000 of salary income each year for the next ten years, after which T plans to retire. After retirement T will need \$100,000 per year to cover his expenses. Currently, T has a \$400,000

high-yield bond portfolio that pays 5% interest, giving him \$20,000 of net investment income each year. If T doesn't sell the bond portfolio, he will pay \$760 per year for the next ten years in NIIT ($.038 \times \$20,000$). Instead, T decides to sell the bond portfolio and use the proceeds to buy a life insurance policy, thus eliminating any NIIT over the next ten years. Suppose that after retirement T's income fluctuates as follows:

1 st year of retirement	\$110,000
2 nd year of retirement	\$90,000
3 rd year of retirement	\$115,000

Since taxpayer needs \$100,000 a year after retirement to live on, he can borrow tax-free from his life insurance policy in his 2nd year of retirement to bring his income up to \$100,000.

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