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Rescuing a Life Insurance Policy with a Loan

Situation: Numerous life insurance strategies involve borrowing against the cash value of a policy. Policy loans can provide a fast and easy source of cash for clients. Often the terms of a policy loan are more favorable than a conventional loan. They do not have the stringent credit and underwriting approval requirements and the interest rates are typically lower. In addition, there are no fixed repayment schedules in that the loan interest can be paid or accrued and can remain outstanding until the insured's death.

The reason life insurance companies can provide favorable terms on a policy loan is because the carrier controls the cash value that serves as collateral for the loan and it will not allow a policy loan to exceed the cash value of the policy. Consequently, the carrier knows that the funds will be available. If the outstanding loan balance gets too close to the remaining policy cash value the carrier simply "forecloses" on the policy. So, the good news is that the policy owner can never be on the hook for a loan that is greater than the policy cash value.

Policy loans also usually receive favorable tax treatment. Specifically, policy loans will not typically trigger current income tax as long as the policy remains in force, even if the total loan amount exceeds the policy owner's investment in the contract (basis).[1] Unfortunately, the bad news is that the lapse, cancellation, or surrender of a policy with an outstanding loan can generate taxable income. Specifically, taxable income will be realized at surrender or lapse of a policy with a loan if the loan amount, including capitalized interest, exceeds the owner's basis in the policy. Furthermore, there will not be any remaining cash value at the "foreclosure" of the policy to pay the tax bill.

Ultimately, the only way a policy with a loan can be received income tax-free is if the policy stays in force until the insured's death. Satisfying the loan from the policy death benefit should not result in taxable income. The reality that the only way to use a life insurance policy's cash value to repay a loan tax-free is by the death benefit leads to a number of rescue strategies to help ensure that the policy stays in force until the death of the insured.

Of course, ideally the preferred strategy is to monitor/manage the policy all along to avoid reaching a situation where the policy needs to be rescued. But sometimes a substantial loan does accrue and it's necessary to take steps to rescue the policy. Fortunately, it's often possible to sustain the policy with some combination of rescue strategy. This Counselor's Corner will review some of the techniques used to rescue a policy with a loan.

Solution: In some cases it makes sense to rescue a policy that is in distress due to a substantial loan either to avoid the adverse tax consequences or simply retain the death benefit. Before getting into the strategies for rescuing a policy it's important to understand where the endangered policy stands today.

Information to Gather. The place to start is with a policy review. Following is some of the key information that must be gathered:

- **Purpose of the policy. Determine why the policy was purchased and whether that reason is still relevant. Establish the reason/need for the life insurance today.**

- **Purpose of the loan. What was the context of the loan? Was it for a temporary need that has ended and can be repaid?**

- **Type of policy. Determine the type of policy (variable, universal, whole life, combination etc.), the actual death benefit amount, and the riders/options it provides. If it has an "overloan" feature assess requirements that need to be satisfied to trigger the feature. Many older policies do not have this feature.**

- **Verify cash value and loan. Check the actual policy cash value and the amount of policy gain (cost basis of the policy). Determine the amount of the loan, type of loan (fixed, variable etc.), the loan interest rate and what it would take to retire the loan.**

- **Check the insured's underwriting qualifications: Check health, avocation, and smoker status of the existing policy as well as his/her current status. Of course, changes in health in either direction can have a significant impact of available options.**

- **Verify the policy owner and beneficiary structure. Determine if the insured or a third party is the owner. If a third party is involved making premium payments can have gift implications.**

- **Determine premium commitment and amount required to keep the policy inforce. Determine how much is currently being paid into the policy and how much the owner is willing to commit. Assess whether there are any limits to how much can be committed such as MEC or gifting limits.**

- **Acquire In-Force Ledger. Get an inforce ledger (a projection from the carrier of how it is expected to perform) to help clarify how serious the loan situation is. This will help guide cost and consequences of the rescue options.**

Once the background information has been gathered it's possible to evaluate possible loan rescue strategies.

Add Cash To the Policy. The first approach is to simply put more money into the policy. Even if the loan is not totally eliminated, reducing the loan balance will increase the likelihood that the policy will last until it matures as a death benefit. This approach is especially appealing if the policy owner has a substantial amount invested in low yielding assets in comparison to the loan interest rate.

If there is not enough money to repay or reduce the loan another option is to begin paying the interest on the loan in addition to the premium payment. To the extent the policy cash value continues to grow, while the loan interest rate is being paid, it's more likely the policy will sustain itself. In a universal life policy where there is no direct requirement for premium payment since the crediting rate on the policy is typically lower than the interest rate on the policy loan, extra dollars should usually be used to pay down the loan first.

Where a third-party is the policy owner this strategy must consider gift tax consequences. Of course, this option assumes the policy owner is able and willing to make the necessary payments . . . which is not always the case.

Restructuring the Policy. In an effort to save a policy with a loan another option is to restructure the policy. The form of restructuring option depends on the type of policy and riders.

First check to see if the policy has an overloan lapse protection rider. This rider essentially converts the policy to a paid-up policy where loan balances exceed a certain threshold to avoid lapse. This rider is more common on universal life policies than it is on whole life contracts. And, as indicated above is not on many older policies. The exact parameters of how and when the rider can be used varies by carrier. Most of these riders require a proactive election to receive the benefit. Typically, there is a charge at the time of election While the objective of the election is to avoid adverse tax consequences that often result from a policy lapsing, neither the IRS or courts have ruled on the tax consequences of exercising the rider. Regardless, the rider adds a layer of protection.

For participating (pays a dividend) whole life policies there are several options for how dividends can be used. A common dividend option purchases paid-up additions (PUA), which means dividends are being used to purchase small amounts of additional paid-up insurance coverage. This is not a good dividend option when there is a loan. Fortunately, dividend options can be changed by simply making a request to the carrier. For policies with loans usually the best dividend option is to direct the dividends to pay the loan interest and if the dividend is larger than the interest, to pay down the loan.

In addition, with a participating whole life policy it's possible to do a partial surrender of just the PUAs. Since this part of the coverage is already paid up the cash value tends to be high relative to the death benefit, which means the policy owner is giving up less death benefit. The partial surrender or withdrawal (where possible) of cash value to pay down a loan is treated as a reduction of basis first and not taxable until all basis is paid out.

If the policy is a universal life policy there are a couple of different options to reducing the impact of a loan. One option is to reduce the face amount. A death benefit reduction reduces the ongoing cost of insurance extending the life of the policy. Another possible option is to take withdrawal from the policy cash value to pay down the loan. As long as the policy is not a MEC (Modified Endowment Contract) or subject to the 15-year force-out for overfunded policies withdrawals from a policy are treated as basis first and are not taxable until all basis is paid out.

Using a 1035 Exchange. If the policy owner is not able or willing to put in additional cash and restructuring a policy isn't enough another option is to explore replacing the policy through a 1035 exchange. Another reason for doing an exchange may be to add the overloan protection benefit. Of course, an important caveat of doing a 1035 tax-free exchange with a policy with a loan is that the new policy must take on an identical loan.

Not all carriers are willing to accept policies with loans and those that do set limits on the amount of loan they will accept. So, it's important to understand carrier guidelines. Of course, the exchange must involve the same owner and insured, but the type of policy can be different (i.e., whole life can be exchanged for a universal life policy) and the face amount can be different from the old policy.

A 1035 exchange may not be viable if the insured's health has deteriorated. However, in some cases a replacement may be attractive where the insured's health has improved, or the new policy can be acquired with better pricing or desired features (i.e. long-term care rider). Furthermore, it's also possible to get loan provisions at more favorable rates than under old policies.

Surrendering or Selling the Policy in a Life Settlement Transaction. Where the policy cannot be effectively saved the last option is to just let it go. The simple way to do this is to contact the insurance carrier and request a surrender of the policy. Taxable gain will still be assessed, but to the extent there is any cash value remaining it can help to cover the tax liability.

Before taking this course of action it's a good idea to ask the carrier to do a gain calculation so the policy owner is aware of the tax liability. If the tax liability is significant this might encourage the owner to reconsider the other options. Of course, this strategy is not a good idea if the insured is in poor health and there is a possibility of a death payout in the near future.

Another option for an older or unhealthy insured is a life settlement transaction. A life settlement is the sale of a life policy to a third-party. In an appropriate situation the third-party buyer will pay more than just the remaining cash value. This strategy will be most beneficial for an insured who has a significant health impairment. The transaction is still taxable, but if a greater payment can be received by the policy owner this strategy provides more cash to help pay taxes.

Summary. By taking steps to engage in a life insurance policy loan rescue financial advisors can potentially ensure that a policy with a significant loan doesn't turn into a policy lapse and an income tax liability. However, it's important to note that even after performing a policy loan rescue, it's still important to provide ongoing management of the "rescued" policy.

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[1]*Lifetime distributions from a MEC are taxed differently than distributions from non-MEC policies. Unlike non-MEC policies, loans from a MEC are taxed as ordinary income when received to the extent that there is a gain in the contract. In other words, loans (as well as wwithdrawals) from a MEC contract are taxed as income first and recovery of basis second until all gain has been withdrawn or borrowed.*

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