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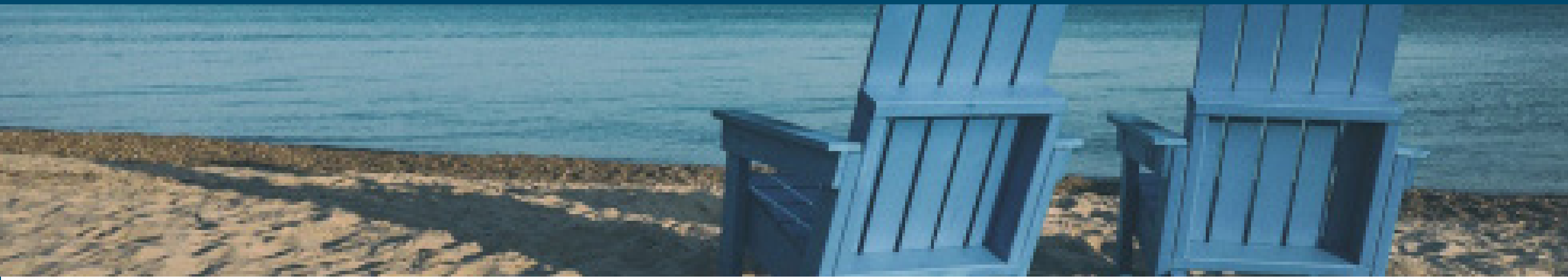

Complexities of Using Life Insurance as a Retirement Supplement

Situation: Early in our insurance careers, many of us learned that life insurance enjoys many tax-favored benefits. Specifically, we learned that unlike annuities, withdrawals from a life insurance policy are not taxable to the extent they do not exceed the cost basis of the policy. Furthermore, loans of any amount permitted by the insurance carrier can be taken income tax-free.[1]

Because of the tax-favored treatment of withdrawals and loans from a life insurance policy, many strategies promote the use of taking withdrawals equal to basis then loans thereafter as a way to access policy cash values to help clients supplement retirement income. The practical effect of such a strategy is that the policy owner is able to enjoy the policy cash value without income tax consequences. However, when considering the use of life insurance as a retirement supplement there are product features and tax aspects that should be considered. This Counselor's Corner will provide guidance on some of considerations that should be evaluated when there is a desire to access life insurance policy cash values.

Solution: In addition to conducting periodic policy performance reviews when you find that you have a client that plans to access their policy cash values at some point in the future, there are specific policy features you will want to pay attention to at the time the policy is purchased. Following are some of the key product features to examine:

- First, if the product is a flexible premium structure you will want to decide which of the life insurance definitions to use.[2] The GPT (guideline premium test) life insurance definition is used to minimize mortality drag. However, advisors should note that unlike the CVAT (cash value accumulation test) definition, the GPT definition limits the amount of premium that can go into a contract. While GPT may "illustrate" the best supplemental retirement income values, it can create a Catch 22 where a policy needing premium in order to be sustained is deprived of that premium due to GPT premium limits. This problem can be avoided by using the CVAT definition.

- Also, it may be helpful to run the illustration with lower assumed crediting rates to see how the product performs.

- Next, since withdrawals in excess of policy basis will usually be structured as loans, you should have a clear understanding of the loan options (fixed, indexed, variable, preferred, "wash"), how often it can be changed and how interest will be credited to the values associated with the policy loan. When taking policy loans, the relationship between the interest charged on a loan and the interest credited to cash values attributable to the loan is very important to understand to avoid unnecessary risk and policy costs.

- Finally, significant policy loans can cause a policy to lapse. Therefore, you may want the policy to have an overloan protection rider that, when elected, will prevent an unwanted policy lapse. It's important to have an understanding of the limits of this feature.

[1] Unpaid loans and/or withdrawals cause a reduction in policy cash values and death benefits and may affect policy guarantees against lapse. Loans outstanding at policy lapse or termination, prior to death of the insured will cause immediate taxation to the extent of gain in the contract.
[2] All life insurance products must meet specific requirements to be classified as life insurance. If the product fails to meet the requirements it will be reclassified as an investment and lose almost all of its tax benefits. The qualification is done by passing one of the following two definition tests: cash value accumulation test (CVAT) or guideline premium test (GPT). Whole life contracts use CVAT while flexible premium products such as universal life, index universal life and variable universal life have a choice to use either. The selection must be made at the time product is illustrated and purchased.

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When using life insurance as a supplemental retirement source it's important to not just consider the product features; you also need to avoid the tax land-mines. The two of the most common ways to lose the favorable tax treatment of life insurance involves heavily funding a policy such that it is classified as a modified endowment contract or a cash rich policy.

Modified Endowment Contract

One way the tax-favored treatment of life insurance can be lost is by paying too much premium during the first seven years of the contract (or in the 7-pay period after a material change), causing the policy to be classified as a modified endowment contract (MEC). Death benefit from a MEC is still generally received income tax-free under IRC § 101(a). However, lifetime distributions from a MEC are taxed differently than distributions from non-MEC policies. Common policy distributions include withdrawals, loans, and assignments. Distributions from a MEC are taxed as income first and recovery of basis second. Furthermore, the portion of any distribution that is included in the policy owner's gross income may be subject to a 10% tax penalty if the policy owner is under age 59 ½. Thus, the taxation of a MEC is similar to the taxation of a deferred annuity.

Withdrawals from a Cash Rich Policy

Another way the tax-favored treatment of life insurance can be lost is by violating what is sometimes referred to as the "cash rich rules." In general, the rules affect policies with large premiums relative to the death benefits that are issued or exchanged after 1984. According to the cash rich rules, anytime there is a cash withdrawal from a policy that results in a reduction of the death benefit within the policy's first fifteen years there is the possibility that some portion of the distribution will be subject to income tax.

Fortunately, it's possible to avoid unfavorable tax treatment with a little advance planning. First, if the policy becomes a MEC because of excess payment, the insurance carrier is required to notify the policy owner and provide him/her an opportunity to request a refund to avoid MEC status. It should be noted that there are situations where excess premium payment is required to keep the policy in force. If excess premium payment is required to keep the policy in force, options specific to the client will need to be explored.

The best way for your clients to avoid problems created with distributions from a heavily funded cash rich policy is to ask the carrier to perform a cash rich test prior to taking a withdrawal to determine if any part of a proposed distribution will be subject to income tax. Alternatively, you can have the client wait until year sixteen before taking a withdrawal because the cash rich rules do not apply once you are past the 15th policy year. Finally, if waiting is not an option, your client can take a policy loan prior to year 16 because policy loans do not typically reduce the policy death benefit; thus, they do not trigger cash rich testing.

In Summary. When using life insurance as a supplemental retirement source it's not only important to avoid the tax land-mines, you also need to consider the practical things like the impact changes in crediting rates and loan assumptions can have on the long-term viability of the arrangement. For example, recently I reviewed an illustration where a mere .7% decrease caused the policy to lapse at the insured's age 83. Even more problematic the policy would not accept additional premiums because the proposal used designed using GPT which, unlike CVAT, limits the amount of premium. Unable to prevent the policy from lapse, the insured would end up recognizing significant phantom income. When using life insurance as a retirement supplement the policy performance must be stress-tested at time of issued and continuously monitored after the sale to avoid unexpected tax land-mines.