WRMarketplace
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BENEFITS | INSURANCE | INVESTMENTS

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Life Insurance Policy Loans – What You Don't Know Can Hurt You.

MARKET TREND: Clients concentrated in illiquid investments or closely-held businesses not only face liquidity concerns at death, but often need quick and easy access to interim sources of liquidity during life. With proper planning, the features of permanent life insurance coverage, including the ability to take policy loans, can satisfy both of these needs.

SYNOPSIS: For permanent life insurance policies, policy loans offer an efficient method for accessing a policy's cash value during the insured's life, generally with more ease and on terms more favorable than conventional loans. However, the satisfaction of outstanding policy loans from the proceeds of the terminated, cancelled or surrendered policy may result in taxable income to the policy owner, even if the policy owner does not receive any direct distributions (i.e., phantom income). Thus, policy loans require active monitoring and management to avoid unexpected tax exposure.

TAKE AWAY: Policy loans can provide an efficient and quickly accessible interim liquidity source for illiquid clients but can generate unexpected tax liabilities if the policy is terminated with an outstanding loan. To use policy loans most effectively, clients (1) must understand the economics of the loan, including the mechanics of interest accrual and compounding and the overall impact on the policy's performance and death benefit, and (2) should regularly monitor the loan to confirm that the projected policy performance and the planned repayment strategy remain optimal. Advisors can add value by providing in-force illustrations showing the projected effect of a proposed policy loan, and, if a loan is taken, by providing updated illustrations on an annual basis.

A policy loan is a common method for owners of permanent life insurance policies to temporarily access the policy's cash value during life. Careful planning is required, however, to ensure such loans do not result in exhaustion of the policy death benefit at death or cause a policy lapse during life, with the potential recognition of taxable "phantom income" due to the satisfaction of the policy loan from the policy proceeds at termination.

OVERVIEW

An owner of a permanent life insurance policy (*e.g.*, whole, universal and variable life) can borrow from the policy's cash value through one or more loans. Each policy loan will accrue interest, which will be accumulated and added to principal if not paid on a current basis. These loans will reduce the policy death benefits if they remain outstanding at the insured's death.

Generally, for federal income tax purposes, policy loans constitute bona fide indebtedness rather than distributions or withdrawals of cash value. Note that for policies classified as modified endowment contracts ("**MECs**"), however, policy loans are treated differently and taxed more similarly to policy distributions. Thus, ***this article does <u>not</u> discuss the general tax rules applicable to policy loans from MECs***.

POTENTIAL BENEFITS

<u>Efficient Access to Cash Value</u>. With proper management, policy loans can provide an efficient method for accessing policy cash value during the insured's life. The policy loan should not 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 (*i.e.*, "basis," which generally equals the total policy premiums or other consideration paid less prior amounts received under the policy that were excludable from gross income).[1] In contrast, amounts withdrawn (and not borrowed) from policy cash value in excess of policy basis generally are taxable in the year of withdrawal. Thus, policy loans can allow policy owners access, without current taxation, but subject to interest charges and the ultimate repayment obligation.

<u>Favorable Loan Terms</u>. Policy loans offer several advantages when compared to conventional market loans. They do not have stringent credit and underwriting approval requirements like conventional loans, and the interest rates typically are lower than current market rates. In addition, there typically is no repayment timeframe (e.g., no fixed payment schedule, interest can be paid or accrued, loan can remain outstanding until insured's death), although long-term interest accrual and outstanding loans can adversely affect the policy's performance and the policy's death benefit, as discussed below.

<u>Avoidance of Taxable "Force-Outs."</u> A withdrawal of value in the first 15 years of a policy that reduces the future death benefits may cause inclusion of the withdrawal in gross income to the extent of the policyholder's gain in the contract, up to a "recapture ceiling" (also known as "forced-out gain").[2] This 15-year rule does <u>not</u> apply to typical policy loans, since they are not treated as distributions and do not result in immediate reduction of policy death benefits.

<u>Liquidity Source</u>. Policy loans can provide a quick and easy source of cash for clients who are heavily concentrated in illiquid or inaccessible investments (*e.g.*, closely-held business, private equity investments, real estate, etc.), particularly when a liquidity event, like the sale of a company, is expected. Policy loans also may be used as part of an exit for other financing strategies, for example, if a policy owner currently lacks cash to repay a split-dollar loan arrangement that has become due or otherwise unfavorable (although, as discussed below, the policy loan itself also should have a plan for repayment).

SOME POTENTIAL ISSUES

<u>Tax on Policy Lapse, Cancellation or Surrender</u>. As confirmed in recent Tax Court cases, the satisfaction of a policy loan from policy proceeds upon the policy's lapse, cancellation, or surrender generates taxable income if the total loan amount, including capitalized interest, exceeds the owner's basis in the policy. This rule applies whether or not the policy termination is voluntary and regardless of whether the policy owner receives any actual proceeds.[3]

> ***Example:*** Policy owner, B, who is taxed at maximum income tax rates, takes $100,000 in policy loans. Each loan accrues annual interest that is added to the loan principal if not paid. B never repays any part of the loans. The carrier eventually initiates termination of the policy, applying all the policy proceeds to satisfy the outstanding loans. At termination, the total outstanding loan amount (including capitalized interest) is $196,000, and B′s basis in the policy is $86,000. B is subject to income tax (at up to 39.6%) on $110,000,[4] representing the difference between the outstanding loan amount and B′s basis in the policy. Thus, B may incur income tax of over $43,500, even though B did not request or direct the policy termination and did not receive any proceeds from the policy to offset the liability.

If the policy remains in force and the policy loans remain outstanding until the insured′s death, satisfying the loan from the policy death benefit should <u>not</u> result in income tax. It may, however, undermine the purpose of the life insurance protection, leaving policy beneficiaries with little remaining death benefit at a time when liquidity is needed.

<u>Capitalizing Interest</u>. Like conventional loans, policy loans accrue interest charges that will be added to the loan principal if not paid. Failure to pay the interest essentially results in additional borrowing from the policy as the principal balance grows with the capitalized interest. This continued compounding can quickly lead to a significantly higher loan amount and an erosion of the policy′s cash value. For example, capitalizing the interest on a $500,000 policy loan at a 5% annual interest rate would generate an outstanding loan balance of $814,000 after 10 years. Thus, policy owners will need to track the interest accrual on policy loans and may want to consider paying interest currently to avoid excessive loan balances. Policy owners should also monitor the interest rate applicable to the policy loan, which may be variable (depending on the policy and loan options available) and thus may increase over time.

<u>Policy Loans to Pay Premiums</u>. Using a policy loan to cover a premium payment may make sense when a policy owner experiences a temporary or intermittent lack of liquidity. Systematic use of policy loans to pay premiums, however, may severely impact the policy′s performance, and likely will accelerate the point at which the loan balance exceeds the policy′s basis and then reaches the maximum loan amount allowed. In these cases, lapse or termination of the policy may result in adverse tax consequences, as discussed above.

Note that some insurance policies provide for automatic policy loans to cover unpaid premiums, and carriers may continue to make these loans for unpaid premiums until it forces a policy lapse or termination. Policy owners unaware of these automatic loan provisions could find themselves not only surprised by a notice of lapse but shocked at the fact that they could owe income tax on this phantom income. Thus, it is crucial that policy owners pay close attention to the premium payment and loan options selected under their policies.

<u>1035 Exchanges</u>. As noted in *WR Marketplace No. 14-19*, a ″1035″ tax-free exchange[5] of a policy subject to an outstanding loan for a new policy generates boot if the new policy is not subject to similar indebtedness and policy cash values are used to satisfy the loan.[6] The client will recognize gain equal to the lesser of the terminated loan or the difference between the policy′s cash value and the client′s basis in the old policy. To avoid boot in these cases, a client can try to exchange the original policy for a new one subject to the same loan amount or pay-off the policy loan before the exchange by using other assets.

KEYS: UNDERSTANDING THE ECONOMICS

Run the Numbers. Understanding the economics of policy loans is critical to their successful use. Although called a "loan," technically, the policy owner is borrowing from his or her own money – i.e., the premiums the owner paid and growth thereon. The loan, while outstanding, not only accrues interest, but also reduces the policy's cash value (and can reduce the ability to generate earning on the loaned amount) and the policy's death benefit.

While paying to use your own money, on top of reducing the cash value of, and the insurance protection offered by, the policy, may not seem economically practical, in the right context, policy loans may make economic sense. For example, a closely-held business owner has most of his assets concentrated in his business but anticipates a sale of the company in three years. He needs an infusion of cash now, but obtaining a conventional loan will require significant time and effort to compile the necessary financial information and complete the approval process and will also charge a higher interest rate than a policy loan. In this case, the ease, lower interest rates and immediacy of the policy loan may outweigh the economics of obtaining a conventional loan.

In any case, insurance advisors can assist clients by "running the numbers" before they take a policy loan, including providing accurate, in-force illustrations regarding the impact of the available types of policy loans on the policy's performance, how the projections are altered by capitalizing or paying interest or repaying the loan within varying timeframes, etc. Advisors should also review potential repayment strategies, including what assets will be used for repayment and how they will affect the policy (*e.g.*, if policy death benefits will be used, will the policy sustain until the anticipated payment of those benefits and will sufficient benefits remain for the policy beneficiaries after repayment).

TAKE-AWAYS

- Policy loans can provide an efficient and quickly accessible interim liquidity source for illiquid clients but can generate unexpected tax liabilities if the policy is terminated with an outstanding loan.

- To use policy loans most effectively, clients (1) must understand the economics of the loan, including the mechanics of interest accrual and compounding and the overall impact on the policy's performance and death benefit, and (2) should regularly monitor the loan to confirm that the projected policy performance and the planned repayment strategy remain optimal.

- Advisors can add value by providing in-force illustrations showing the projected effect of a proposed policy loan, and, if a loan is taken, by providing updated illustrations on an annual basis.

NOTES

[1] *See e.g., Reinert v. Commissioner*, T.C. Summary Opinion 2008-163 (2008). But, as discussed herein, policy loans can generate taxable income if a policy is terminated or surrendered with outstanding policy loans that exceed the policy's basis.

[2] Code §7702(f)(7).

[3] *See*, *e.g.*, *Black v. Commissioner*, T.C. Memo 2014-27 (2014) (as reported in *WRNewswire 14-02-18)*; *Brach v. Commissioner,* T. C Summary Opinion 2013-96 (2013) (as reported in *WRNewswire 13-12-18). See also Brown v. Commissioner*, 693 F.3d 765, (7th Cir. 2012), aff'g T.C. Memo. 2011-83; *McGowen v Commissioner*, 438 Fed.

Appx. 686 (10th Cir. 2011), aff'g T.C. Memo 2009-285; *Reinert v. Commissioner*, T.C. Summary Opinion 2008-163 (2008); *Atwood v Commissioner*, T.C. Memo 1999-61 (1999).

[4] And potentially net investment income tax of 3.8%.

[5] Pursuant to Internal Revenue Code §1035.

[6] Using policy withdrawals to pay-off a policy loan prior to or shortly after the exchange also may result in taxable boot. See *WR Marketplace No. 14-19,*

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