

# A Practical Understanding of Cash Value

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Several recent client conversations about various aspects of life insurance cash value prompt this discussion of cash values—not in a historical and comprehensive sense, but using various anecdotes to pursue a better practical understanding.

## Cash Value Is Not a Bank Account

To quote an awful commercial, “It’s my money and I want it now.”

A client came to me furious because he was being charged interest on cash value loans from his participating whole life policies. Somehow a light bulb went off and he realized his policy was being debited for the loan interest each year. Stan insisted that the insurance company had no right to charge interest because it was his money, like a bank account. This isn’t the way life insurance cash value works.

Life insurance as an asset is not dissimilar to, say, apartment units—if you want cash from the apartment asset (or your life insurance) you take a mortgage (loan) and pay interest. This

reduces the net value of the apartment asset (life insurance death benefits) by the amount of the mortgage (loan). Or you could sell some units (withdraw cash value), receiving cash without creating a mortgage (loan), but also reducing the net value. Life insurance cash value is not a bank account.

“When a policy lapses with no value with taxable income there are no funds from the policy to pay the taxes. This is known as phantom income.”

## Unattended Cash Value Loans Can Crater a Policy

John’s loans accumulated because of a combination of factors. His agent left the business. When John moved, the insurance company lost track of the correct address to send premium notices, so John didn’t receive them. John didn’t pay premiums thinking they were covered within the policy. They were, by loans, and eventually the policy reached a tipping point and

was in danger of lapsing with phantom income within a year.

John, believing the cash values were his to do with as he pleased, then spent hours in discussions and written communications with the insurance company trying to pin blame for this situation. He threatened legal action. He churned up a lot of frustration. Even if the company mismanaged this situation, the cost in money and time would have produced a huge net loss to John. The amount at stake is very small.

As noted with Stan, cash value life insurance with a large loan can cause a policy to lapse without value, but with taxable income. This is because the cash value loan value (known in the tax world as *boot*) is the gross value of the policy when it lapses. The insurance company’s calculation of the cost basis is subtracted from the gross value and the difference is the reportable taxable income. Note that when a policy lapses with no value with taxable income there are no funds from the policy to pay the taxes. This is known as phantom income.

I determined that John had three choices to rescue the situation, but only one that was in his best interest. Fortunately, John had a relatively high net worth with cash resources. Repaying the loan of some \$46,000 would immediately raise the cash value by about an equal amount and

the death benefits from some \$28,000 to \$81,000. Taking into account the payments and death benefit payout at John's life expectancy, the yield is 3.14 percent income tax-free based on the current dividend. In this low fixed-income yield environment, this is a decent return. More to the point, this was the only way for him to have a positive outcome with this policy. All the other options produce negative financial outcomes, including repaying the loan and then terminating the policy for its surrender value because this would produce significant taxes. Because of his negative feelings generated for this insurance company during his long battle, he only reluctantly repaid the loan.

Astonishingly, during the long ordeal, the insurance company spent most of its time defending its practices. To the extent it suggested repaying the loan as the only real solution, John didn't accept it because of his total mistrust.

### Account Value and Cash Value Are Not the Same

Almost all universal life (UL) policies have significant surrender charges that are listed in the contract. They also show up as the difference between the account value and the cash value in statements and illustrations. Many clients and advisers don't understand the difference.

Let's say a \$1 million UL policy has a \$100,000 account value and a \$50,000 cash value. The surrender charge is \$50,000. The client could borrow or withdraw against the \$50,000 cash value, but not the account value. If the client were to withdraw most of the cash value, the policy could continue for quite some time because the monthly insurance charges are deducted from the account value of ~ \$50,000.

Let's say that client wants to reduce the policy from \$1 million to

\$500,000. This would cause half of the \$50,000 surrender charge to be incurred, or \$25,000. After the reduction to \$500,000 the account value would be \$75,000 while the cash value would remain at \$50,000. Because the surrender charges go down each year, this is a real loss in policy value. The account value offset by the surrender charge is a way for the insurance company to hide the sales commissions. If the commissions are lower, the surrender charges are lower, and the liquid cash value is higher. This can be done on some ULs (not all) by demanding that blending be used to replace base death benefits with term insurance. This blending alters nothing in the UL's pricing, except to reduce the commissions and surrender charges and increase the cash value.

“The secret to effective UL cash value management is not to build it up in the first place.”

### Can I Have My Cake and Eat It Too?

A client reviewing his annual UL statement showing \$2.5 million cash value for his \$10 million policy had a question, then an epiphany—does the cash value add to the death benefit? The answer is no. Then why not take out most of the cash value? There are two reasons why this shouldn't be done.

First, borrowing or withdrawing cash values will reduce the death benefit by the same amount, so nothing is gained. Second, the cash value is the foundation of a permanent current

assumption UL (as opposed to a guaranteed UL). The target premiums are set up to levelize the annual cost with build-up of cash value used to support the increasing cost of insurance charges as insureds get older, with the account value reducing the amount of actual life insurance. The overall management of a level death benefit UL policy needs to take into account the insured's possibly changing health so the target funding age is accurate. For a healthy insured, we need to fund the policy as if he or she will live to 100 or beyond—lifetime funding. Depending on the type of policy, this may mean generating a cash value equal to the death benefit at 100.

In others, we only need \$1 to continue lifetime beyond 100. But if an insured incurs significant health issues, we may decide to fund the policy to an earlier age, say, 85 if the probability of living to 85 is low because of health issues. The goal is to have \$1 of cash value when the insured dies. This, of course, is a theory and not reality, but we can save significant premiums by assessing mortality prospects and minimizing the cash value build-up when mortality probabilities are in favor of dying around 85, not 100. The secret to effective UL cash value management is not to build it up in the first place because as noted, you can't get it out without reducing the death benefits.

Guaranteed UL has low to zero cash values. Unlike other permanent policies that terminate if there is no cash value, guaranteed UL depends on a specified premium being paid as contracted for the coverage to remain in force regardless of zero cash values.

Permanent life insurance must be managed around those all-important cash values. Use astute judgment about how they are used, and you can get maximum effectiveness out of the policy. ■