Cash Value Life Insurance for the Bad Times

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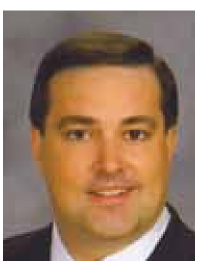

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All financial planners know that life insurance serves as a cornerstone of a client's risk management plan by preserving the insured's human capital for named beneficiaries in the event of an early death. Although the death benefit protection should be the primary purpose of life insurance, cash value policies can also provide some planning flexibility for a client, especially in times of economic uncertainty. Of course, planners must consider the specific circumstances and needs of the client when determining the appropriate type of life insurance to recommend, but it is prudent to consider the planning flexibility of cash value life insurance when making the purchase decision. Access to policy loans is an important aspect of that flexibility.

Hard Times Lead to Difficult Decisions

The economic uncertainty that has plagued us since 2008 has been well documented. High unemployment, low levels of job creation, declining incomes, and reduced access to credit have presented challenges for many. Although the credit crisis and the effect of deleveraging on individuals and the economy is a topic of lively debate in the academic and popular media, the real impact of these phenomena directly affects the planning choices clients are making.

Recently published studies on participant use of 401(k) plans raise concerns that the economic challenges individuals face and the choices they make in light of those challenges may have long-term effects on their financial security beyond the Great Recession. Studies of recent 401(k) plan participation indicate that many individuals eligible to make 401(k) contributions are forgoing not only the opportunity to make tax-deferred contributions to their plans but also are leaving the matching contributions offered by employers on the table. Furthermore, larger numbers of participants in 401(k) plans are making use of the loan feature offered by the plan. Increased use of loan opportunities from 401(k) plans may seem appropriate given the credit crunch facing many Americans. Some individuals may see this as their only choice if they cannot get additional lines of credit or bank loans, but for some clients, this may not be an optimal choice.

Permanent life insurance policies, like 401(k) plans, also offer loan opportunities for clients. Clients who own permanent life insurance policies who also participate in 401(k) plans may find that borrowing from their life insurance policy is a better choice, both in the long and short run, than borrowing money from their 401(k).

A Simple Case Study

Consider Richard and Hyacinth, who have been married for 25 years and have one son, Sheridan, who is in college. Richard holds a middle management position at a mid-size company, and also runs a small part-time consulting practice. Richard enrolled in his company's 401(k) plan as soon as possible, and shortly after he married Hyacinth, Richard purchased a whole life insurance policy to provide for his family in the event of his early death. The policy is paid up. Hyacinth spends most of her time managing social and charitable affairs, and consequently does not earn a paycheck. Until 2008, Richard's salary and consulting income were sufficient to cover their expenses and pay for Sheridan's college education.

Unfortunately, because of the economic downturn, Richard lost his consulting clients in 2009 and had to accept pay concessions at work in consideration of future employment. Because of these setbacks, the family could not make ends meet on their earned income alone. Richard and Hyacinth did have some nonqualified savings, which carried them through the end of 2010, but those savings are now gone, and Sheridan still has two years to go before he completes college. Richard and Hyacinth cannot borrow against the equity in their home, the value of which has declined in the financial crisis. Richard is fortunate to have some credit cards, but the interest rates on those cards are 19 percent, and he and Hyacinth do not want Sheridan to take out any student loans. It appears that the only options permitting them to get a bit more cash are to: (1) borrow from Richard's 401(k) plan, or (2) borrow from Richard's life insurance policy. Both the 401(k) plan and the life insurance policy offer loan rates of 5 percent.

Why Not Borrow from the 401(k)?

Richard's 401(k) plan includes a loan provision. ERISA and the tax code allow 401(k) participants to borrow up to $50,000 from the plan, or 50 percent of the vested account balance, whichever is lower. Some exceptions to this rule apply for low-balance accounts, but they do not apply to Richard, who currently has $550,000 in his 401(k). If Richard borrows from the 401(k) plan, he will receive a favorable rate of interest (5 percent in this example), and will be permitted to repay the loan over five years. Most likely, his employer will deduct the payments directly from Richard's paycheck and will apply them to Richard's account. The loan will not be treated as a distribution for tax purposes, so Richard will not have to pay income tax on the amount he receives, and he can also avoid the 10 percent early distribution penalty applied to those under age 59½.

Loans from a 401(k) plan create liquidity by permitting access to account balances without immediate adverse tax consequences. Another advantage is that any interest paid on the loan is credited directly to the participant's account in the 401(k). In effect, the participant is paying himself the interest. There are some downsides, however. First, the loan has to be repaid on an amortized basis over a five-year period, which could be burdensome to the participant, particularly if the loan is taken when other financial resources are already stressed. Second, if Richard leaves his company before the loan is repaid, the unpaid balance will be treated as a taxable distribution and will be subject, potentially, to the 10 percent early distribution penalty. Third, if Richard is earning more on his plan investments than the interest rate on the loan, he will be limiting the growth in the account and, ultimately, the amount of his retirement income. Fourth, Richard will be double-taxed on the interest payments he makes on the loan. To make loan payments, Richard will have to use his after-tax income. Although he originally received an income tax deduction for contributions to the 401(k) plan from which the loan is made, it is unlikely Richard will qualify for a tax deduction on the interest payments. Although the after-tax interest payments are credited to Richard's account, when he withdraws those amounts in retirement, he will have to pay income tax on those amounts again.

The Life Insurance Alternative

Instead of taking a loan from his 401(k), Richard could take a loan from his life insurance policy. If Richard takes a policy loan, there is no requirement that he pay back the loan over a five-year period. Instead, the loan can remain outstanding until Richard's death. This option may be particularly attractive in an economic downturn, and may permit Richard to borrow less from the life insurance policy than the 401(k). When the economy picks up, or when Sheridan graduates from college and Richard has some additional free cash flow, he can pay the loan back. Alternatively, assuming that the cash value is sufficient, Richard could borrow additional amounts later, as needed.

Another advantage is that failure to pay back the loan, provided the policy remains in force until his death, will not trigger a taxable event or early distribution penalty for Richard. Like the 401(k) loan, there may be an earnings shortfall equal to the difference between the investment rate of return on cash value investments and the policy loan rate. Unlike the situation with the 401(k) loan, however, the interest Richard pays on the loan will not be subject to a second round of income taxation, because death benefits received by a beneficiary upon the death of the insured are not subject to income tax.

Final Thoughts

Although cash value life insurance is not appropriate for all clients, planners recognize the tax advantages and typically view the cash values as part of the low-risk portion of the client's portfolio. Still, planners often dismiss the use of permanent life insurance policies during good economic cycles when investment returns exceed returns on life insurance policy cash values. As we have seen over the past few years, however, good economic times do not exist forever. During economic downturns, having access to a pool of money on a tax-free basis without having an obligation to repay those funds could be advantageous to a client.

When considering the appropriate type of life insurance to purchase, planners should consider these features in light of client goals and objectives. Understanding the trade-off between current investment returns and flexibility may make permanent life insurance an attractive option for many clients.

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