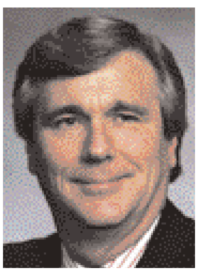
Managing Life Insurance: Loans or Withdrawals?

by Peter C. Katt, CFP®, LIC



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Managing life insurance policies on which clients acquire loans is a challenge compared with policies with no indebtedness. The only way to see policy effects clearly is to obtain various illustrations showing future policy values in the presence of loans or cash withdrawals. Generalizing is difficult because companies and policies within companies can have different ways of dealing with policy loans and withdrawals that can't be intuitively inferred, and that's why getting the illustrations is important.

Policy loans versus withdrawals will have different effects on the policy at various times in the future. One absolute rule to follow is that withdrawals should be avoided if they would create taxable income. Taxable income occurs when more than the cost basis is withdrawn, or the policy is a modified endowment contract.

Let's review issues.

UL

Jim, 65, has a conventional $1 million universal life (UL—that is, not a no-lapse) policy taken out 10 years ago. It has a cash value of $200,000. Jim needs $50,000 for a retirement home he is building. If he intends to repay the $50,000, it should be a loan. If Jim does not intend to repay, it should be a withdrawal. Generally cash values and death benefits in the medium- and long-term will be lower if a loan is taken. This is why taking a withdrawal is usually preferable when it isn't going to be repaid. If a withdrawal is taken, Jim might want to increase the death benefit by $50,000 before the withdrawal so the original death benefit will remain at $1 million. This isn't necessary for a loan that will be repaid, because the death benefit generally goes up by the amount of the loan, returning to $1 million. The advantage of either a loan or withdrawal can be verified by obtaining various illustrations prior to making the transaction.

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Long-term unpaid UL loans are some of the most common mistakes I see in my practice. This mistake is easily corrected. After confirming the advantage of treating the loan as a withdrawal via illustrations, we change the loan to a withdrawal. This corrects the mistake.

If Jim had instead purchased a no-lapse UL, he would have less flexibility taking a loan or withdrawal because cash values are quite low relative to premiums paid and can adversely affect the policy's guarantees. The ability to take loans and withdrawals is a significant drawback of no-lapse UL.

Some financial advisers sell conventional UL for the purpose of using cash values for retirement income. Tax-free withdrawals can be taken until they exceed the policy's cost basis, and then loans can be taken. Loans are not taxable. However, policyowners need to be careful about taking too much from the policy and causing it to terminate because cumulative taxes are immediately due upon termination. A huge tax with no cash to pay it can be an enormous problem. This can happen when astute attention isn't paid to a UL's interest crediting and cost of insurance in the long run.

VUL

My comments regarding policy loans and withdrawals for UL apply to variable universal life (VUL) with one very large caveat. Policyowners should be wary of every aspect of VUL, and that includes loans and withdrawals, because of the great liquidity problems when large investment losses are taken. The problem is so great that avoiding policy loans and withdrawals while VUL investments remain in equity sub-accounts is probably wise.

Whole Life

Whole life policy loans and withdrawals have similar characteristics to UL. Usually, loans will work better if the policyowners intend to repay them, but withdrawals work better if the policyowners do not intend to repay. One complication with whole life that doesn't apply to UL is that when withdrawals are taken, the death benefit drops more than the amount of the withdrawal. A withdrawal of, for example, $10,000 could result in a drop in the death benefit of $13,000. In the long run, a withdrawal has a positive affect on policy values compared with a loan, but not in the short run.

As with UL, it is very common in my practice to see whole life policies with long-term loans that aren't going to be repaid. They should be changed to withdrawals. This can substantially improve the long-term value of the policy.

An interesting strategy for clients who have contributed as much as possible to tax qualified plans and education funding such as 529 plans that have investable funds available is to super-fund a whole life policy coordinated with their life insurance needs. This allows the whole life policy to generate maximum cash value for retirement funding. In retirement, usually withdrawals, not loans, can be taken tax-free until they equal the policy's cost basis for retirement. The policy's residual death benefits can then be used as an inheritance—freeing up other assets to be used in retirement.

Conclusion

Cash value (permanent) policies generate cash values that can be used for unexpected bridge borrowing, long-term funding, and to assist with retirement income. Whether money from policies is treated as a loan or withdrawal can produce significant differences in long-term policy values. Which is better depends on how long the money is needed. Short term usually favors taking loans. Long term usually favors using withdrawals. A common problem is policies that have long-term loans that have been forgotten. This error can be easily corrected.

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