Using Cash Value Life Insurance

Accumulating Funds to Meet Savings Goals

Saving money to reach an accumulation goal is a problem many of us face. Some goals, such as retirement or a college fund for a child, are long-term savings goals. Many of us also have shorter-term savings goals such as a vacation or a Christmas or holiday fund.

Whatever the objective, the basic problem is the same, i.e. where to put money aside to reach a particular savings goal. For many short-term goals, a savings account at a local bank or credit union is a popular choice. For college funding, Coverdell IRAs or IRC Sec. 529 plans are often used. For retirement savings, many individuals depend on Individual Retirement Accounts (IRAs) or employer-sponsored retirement plans such as an IRC Sec. 401(k) plan.

An additional option for long-term savings, one that is sometimes overlooked, is using a cash value life insurance policy.

What is Cash Value Life Insurance?

Life insurance comes in two basic variations, “term” insurance and “cash value” life insurance. Term life insurance can be compared to auto insurance. Protection is provided for a specified period of time or “term.” No death benefits are paid unless the insured dies during the term the policy is in force. If the insured lives beyond the term period, the policy generally expires with nothing returned to the policy owner.

In addition to providing a death benefit, “cash value” life insurance also provides for the tax-deferred accumulation of money inside the policy. These funds can be used by the policy owner while the insured is alive to provide the resources for needs such as funding a college education, making improvements to the home, or starting a business. When the policy owner uses the cash values to meet such needs, he or she is said to have used the “living benefits” of a cash value life insurance policy.

When to Consider Cash Value Life Insurance

Using a cash value life insurance policy to reach a saving goal works best in certain situations:

- **A need for life insurance death benefit:** Apart from the need for additional savings, an individual should have a need for the death benefit that life insurance provides. For example, such a need exists when an individual has a dependent spouse or children who would suffer economically if the individual died. Someone with a large estate might need additional cash at death to pay estate and other taxes as well as final expenses.

- **Other savings aren't enough:** Because of limitations in federal tax law,[1] other accumulation vehicles might not allow enough money to be put aside to meet a particular savings goal.

- **Time frame:** Ideally, there should be at least 10 to 15 years between today and the time the money will be needed. Because of mortality expenses and other policy charges, significant cash value accumulations are generally deferred until a policy has been in force for a number of years. Additionally, federal income tax law affects the design of cash value life insurance policies as well as the taxation of cash value withdrawals in the early years a policy is in force.

- **Insurable:** The insured needs to be healthy enough to have a policy issued on his or her life.

- **An ongoing obligation:** Cash value life insurance policies tend to have a higher premium cost than comparable term life policies. Paying the premiums over a number of years represents an ongoing financial obligation, to both keep the policy in force and achieve the savings goal.

Income Tax Considerations

There are a number of income tax issues to keep in mind when considering any life insurance policy. The death benefit payable under a life insurance contract because of the death of the insured is generally received income-tax free. Federal income taxation of life insurance "living benefits" is more complicated:

- **Tax-deferred growth:** The growth of cash value inside a life insurance policy is tax-deferred.

[1] The discussion here concerns federal income tax law. State or local tax law may vary widely.

- **Cost recovery rule:** Amounts withdrawn from a cash-value life insurance contract are included in gross income (and become subject to tax) only when they exceed the policy owner's basis in the policy. This basis is also known as the "investment in the contract." This effectively treats withdrawals from the policy first as a non-taxable return of premium and secondly as taxable income.
- **Investment in the contract:** The total of all premiums paid less any policy dividends and any other prior tax-free distributions received.
- **Policy dividends:** Some "participating" life policies pay what are termed "dividends." Such dividends are a return of a portion of the policy owner's previously paid premiums. Policy dividends are not taxable until they exceed the owner's basis in the life insurance contract.
- **Policy loans:** Some cash value life insurance policies allow the policy owner to borrow at interest a portion of the accumulated cash value. While a policy is in force, policy loans are generally not taxable. However, if a policy is surrendered with a loan outstanding, taxable income will result to the extent that the unpaid loan amount exceeds the owner's basis in the contract.
- **Modified Endowment Contracts (MECs):** Some life insurance policies – primarily because there are large premium payments in the early years of the contract – are termed "Modified Endowment Contracts," or MECs. Under federal income tax law, distributions from a policy considered to be a MEC are treated differently than distributions from non-MEC policies. Withdrawals from a MEC (including a policy loan) will first be taxed as current income until all of the policy earnings have been taxed. If the owner is under age 59½, a 10% penalty also applies, unless the payments are due to disability or are annuity type payments. Once all policy earnings have been distributed (and taxed), any further withdrawals are treated as a non-taxable return of premium.

Accessing the Contract's Cash Values

When the time comes to use the accumulated cash values, withdrawals from the policy should be done in such a way as to avoid current income taxation (to the extent possible) <u>and</u> keep the policy in force.

- **Withdrawal to basis:** Initially a policy owner can take withdrawals (partial policy surrenders) until he or she has withdrawn an amount equal to the basis in the policy.

- **Switching to policy loans:** Once the basis has been withdrawn, the policy owner then begins using non-taxable policy loans. The interest payable on these policy loans is typically much less than a loan from a commercial bank or credit union.
- **A combination:** A policy owner can also use a combination of withdrawals and policy loans.
- **Caveats:** There are a number of issues that a policy owner needs to keep in mind:
  - Withdrawals reduce the death benefit available under the policy.
  - If an insured dies with a policy loan outstanding, the policy's death benefit is reduced by the amount of the loan balance.
  - Excessive use of withdrawals and policy loans can result in the policy lapsing. Such a lapse can result in unexpected, negative tax results as well as the loss of a valuable financial asset.

A Multi-function Tool

Used appropriately, cash value life insurance can serve as financial tool with multiple uses. It can be used, in conjunction with more traditional savings vehicles, as a way to accumulate funds for long-term savings goals. At the same time the policy can, if the insured dies, provide a death benefit when the funds are most needed.

Seek Professional Guidance

Determining the appropriate amount of life insurance, the best type of policy to meet the needs of an individual's specific situation, and planning when and how to access a policy's cash values can be complex and confusing. The advice and guidance of trained insurance, tax, and other financial professionals is strongly recommended.

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