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Life insurance policy loans (also known as "Tax-Free" income)

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When an insured is sold a non-MEC cash building life policy (a policy sold with the minimum allowable death benefit so as to minimize expenses and maximize cash value and growth), the sale, in large part, usually revolves around "loans" that can be taken from the policy "**income-tax free**."

In order to understand why life insurance can be such a powerful and tax favorable wealth building tool, you must understand how policy loans work.

You will **pay NO income tax if you borrow cash value from a life insurance policy**, assuming the policy stays in place until death and was not purchased with deductible dollars. This is sometimes confusing for the insured. Often you will hear advisors talk about receiving "tax-free" income from a life insurance policy. That's not technically accurate as you now know. You do not receive "income" from your life insurance policy; instead you access the cash via loans.

Generally, loans are treated as debts, not taxable distributions. This can give you virtually unlimited access to your cash value on a tax-advantaged basis. Also, these loans need **not be repaid** (the loan is repaid at death through a reduction in death benefit).

After a sizable amount of cash value has built up in a policy, it can be borrowed systematically to help supplement your retirement income. In most cases, you will never pay one cent of income tax on the gain.

The main circumstance you will need to guard against is taking too much cash out of your policy through loans. If you do that, you will run the risk of the policy not having enough cash left in it to pay the premiums for you until death.

Typically, cash value policies are funded over a specific period of time, 5-7-10-20 years. If the policy is "over funded" at the "minimum" death benefit, significant cash should grow in your policy. After your premium payment period, there is still an annual cost of insurance that is owed in the life policy. This cost is paid for out of the cash value of the policy.

When an insured borrows cash from a life insurance policy, the policy must stay in place until death (otherwise the insured runs the risk of the loan becoming taxable). Greedy clients or owners who do not budget well can get into a situation where there is not enough cash in the policy in the later years (and after loans) to continue to pay the internal costs of the policy. If the policy does not stay in force until death, the insured will have to pay taxes on the loans received from the policy that exceed the premiums paid.

To guard against the policy lapsing and having a client risk their loans being taxable, newer life insurance policies (like **Revolutionary life**) in the marketplace have added a policy rider that kicks in when you borrow money over the age of 70. The rider once activated guarantees that your policy will **never lapse**; and, therefore, you will avoid any potential that the policy will lapse due to a lack of cash to pay annual expenses in the policy.

More on life insurance policy loans

There are two types of loans available in most cash building policies: 1) wash loans and 2) variable loans. Most companies have created what are called "**wash loans**" to make borrowing from a life insurance policy more saleable. An example is really the best way to explain wash loans. The following is a non-wash loan example:

If an insured has $200,000 worth of cash surrender value (CSV) in a life insurance policy, the insured could call the insurance company and request a "tax-free" loan from the policy. Let's say that loan is $10,000.

The insurance company has to charge interest in the policy on the borrowed money. If loan rate is 8% on the borrowed funds, then the insured's policy is charged 8% interest on the loan and that must be paid every year.

The insured's cash in the policy is still growing but at what rate? If the crediting rate on the cash in the life policy is only 6%, then there will be a shortfall on the interest owed and the cash value in the policy will start to go backwards as it pertains to that $10,000 loan amount.

If too much cash is borrowed and the policy goes backwards for too long, the policy could eventually lapse (which could trigger a taxable event on the money previously borrowed from the policy). Also, to avoid a policy from lapsing, a policy holder can make new premium payments (which is something most insureds do not want to be forced to do in retirement when they planned on removing money from the policy tax free via loans).

What if the insured had a "**wash-loan**" option in the policy? If the insured had a wash loan, the interest charged on the loan would equal the growth rate on the cash in the policy. With a wash loan, the cash in the policy will not have to be used to pay the interest on the loan. Instead, the returns on the cash value will pay the interest.

If the interest on the loan is 8%, the insurance company will credit 8% on the same amount of cash in the life policy so it is a neutral transaction from the insured's point of view. The life policy was charged 8% on the $10,000 loan, but the life policy also earned 8% on $10,000 in the policy to create the neutral position.

"Variable" Loan Option in Life Insurance Policies

While everyone in the industry thought "wash" loans were revolutionary as a way to allow clients to more conservatively pull larger amounts of cash out of their policies, when the new "variable" loans feature came out, that really excited those in the insurance industry.

If you borrow money from the insurance company from your policy, the insurance company will charge you interest on the loan which is due every year. As just discussed, if the policy has a "wash" loan feature, the crediting rate on the cash in your policy will mirror the interest rate on the money borrowed from the life insurance company; and it's a wash/neutral transaction for the insured.

A variable loan option allows the insured to **play the market** a little by allowing the cash in the policy to grow with the equity markets and borrow money from the insurance company at whatever the fixed interest rates happen to be at the time of borrowing. If the cash in a policy grows at a higher rate than the lending rate, you actually **make money on the money you borrowed** from your policy.

Let's say the lending rate today in the policy is 6%. Unlike a wash loan where the cash in the policy would be credited with a return of 6%, with a variable loan, in any given year, the insured has no idea what the investment return will be in the policy.

If you purchased an Equity Indexed Universal Life Insurance (EIUL) policy, the growth in the policy is pegged to the S&P 500 (minus dividends and up to a cap). If S&P 500 returns 10% in a year when there is a loan on the policy with an interest rate of 6%, the insured has a positive arbitrage (meaning the cash in the policy had a 4% positive return on the borrowed funds).

Conversely ─ if the S&P 500 goes negative (which in most EIUL policies will earn a return of zero-two percent in that particular year), the policy is still charged with a loan where the rate is 6%. What that means is that in the year when the S&P 500 underperforms the interest rate on the loan, the principal cash in the policy will have to be invaded to pay that interest.

Better Potential for Growth

The reason you should consider using a life insurance policy with the "option" of using a variable loan is because IF borrowing rates and the S&P 500 perform as they have over the last many years, you should actually make money on the money borrowed from your life insurance policy.

Historically, the S&P 500 has returned in excess of 2% more per year than the borrowing rates used for loans. Will that trend continue? Most likely it will over the long term although as you know: "past performance is no guarantee of future performance."

It's tough to really get a feel for how a positive arbitrage on a loan can benefit you when you start borrowing from your policy. To help crystallize the benefit, I created a life insurance illustration with wash loans and variable loans to show you the difference.

Example:

Assume in this example that the client is male, 45 years old, and in good health. Assume he will fund $10,000 a year into an IULI policy each year until he turns 65 and then will borrow "tax free" from his policy from ages 66-85. Assume the average S&P 500 returns over the life of the policy are 7%. How much could he remove from his policy with wash loans and how much from a variable loan where the interest rate spread is a positive 2%?

If the policy used wash loans where the interest rate is 5% and the crediting rate on the cash at the time of the loan is also 5%, the client could borrow **$31,625** "tax free" from the policy every year from ages 66-85.

If the policy credited, on average, slightly less than 7% a year as a credited amount on the cash value AND the interest rate is 5%, the client could borrow **$46,784** from the same policy from ages 66-85.

I am not so sure that it is wise to assume there will be a 2% spread on average between what the S&P 500 returns and lending rates at the time loans are accessed from a life policy. I also do not believe that the S&P 500 over time will return less than what lending rates are when an insured borrows from his/her policy.

Typically when I run illustrations like the majority you'll see in this book, I manually changed the interest rate on the loan to equal whatever the assumed crediting rate is. In this example, the assumed crediting rate of 7% annually.

Therefore, if I used a 7% loan interest rate, how much could this same client borrow from his life insurance policy? **$37,605** every year from ages 66-85.

I personally have no idea what the S&P 500 will do or what lending rates will be like in 10-20-30 years. What I simply want to do with these illustrations is to come up with something that is not over-the-top aggressive and not pathetically conservative.

I also want to make sure readers understand how life insurance agents can manipulate illustrations to make them look very good based on the best of all worlds. I'll do more of this in an upcoming section when I show you an illustration of what many in the life insurance community think the S&P will return in an indexed life policy.

Further Protection

To further protect yourself in the borrowing phase of using a life insurance policy as a supplemental retirement vehicle, you may want to consider using an EIUL policy (Revolutionary life) that credits 140% of what the S&P 500 returns every year. I like this policy when discussing the Variable Loan issue, and I think with an illustration you'll see why.

Assume the interest rate on a loan from a life insurance policy is 6%. In most policies, if the S&P 500 returns say 4.5%, the insured is going to go backwards by 1.5% in the policy due to the fact that the return is less than the interest rate (the client would have been better with a wash loan). If the insured had a policy that credited 140% of what the S&P 500 returns, the insured would have been credited with 6.3% in the policy and would have done slightly better than a wash loan.

Carrying that forward, what if the S&P 500 returned only 3%? The client would be upside down 3% if the interest rate on the loan were 6% in a normal policy but would only be upside down by 1.8% in a policy that credits 140% of what the S&P 500 returns.

My point is simply that the 140% crediting policy allows for more security for the client and better growth for clients who think the S&P 500 is going to be flat for a period of time.

Switching Between Variable and Fixed Loans

As stated, variable loans are a nice option, but they are also **very dangerous**. Why? It's simple, and let's look at an example.

Assume that Dr. Smith, age 65, borrowed $100,000 from his life insurance policy in 2006. Assume the fixed loan rate is 5.5%. Assume he borrowed out another $100,000 in 2007.

Dr. Smith liked his variable loan in 2006 because his EIUL policy was credited with growth that exceeded his lending rate. Therefore, he actually made money on the money he borrowed.

What about 2007? In 2007, Dr. Smith had $200,000 worth of loans on his policy in a year when the S&P 500 as credited in his policy returned ZERO. Dr. Smith was charged **5.5% interest** on his $200,000 policy loan except the interest rate on the money borrowed from the policy in 2007 was **ZERO**.

Therefore, in year two of the borrowing phase, Dr. Smith **went backwards $11,000** because of the variable loan. If Dr. Smith had used the fixed or wash-loan provision, he would have been credited with **$11,000** on his borrowed funds, which would have paid the interest on the loan.

In 2008, the problem would have been exacerbated because the returns again in the policy were **ZERO**.

How does Dr. Smith get away from using variable loans?

With just about every policy in the marketplace, guess what Dr. Smith must do? He must find the money to **FULLY pay back the loans** to the insurance company before the company will allow him to switch his loans to fixed loans.

Revolutionary Life (RL) allows insureds to switch yearly WITHOUT having to pay back the loan!

You wonder why I always keep talking about **RL**. It's simple—not only does the policy allow clients to borrow more out of it than any other policy in the industry using reasonable rates of return, but **RL** is one of the few policies that allows the insured to switch the **ENTIRE loan** from a variable to a fixed loan in any year **WITHOUT having to pay back the ENTIRE loan first**.

Most IMOs do not push **RL** because of relationships with other companies that pay the IMO for persistency and volume premium (one of the biggest problems in our industry). I know that many insurance agents have bonuses, trips, deferred compensation plans, etc., at certain companies, which is why they keep using inferior products. However, I recommend you to learn about the product that will protect your clients more than any other in the marketplace (**RL**) and help you provide the best service and **avoid lawsuits** (and it might behoove you to seek out an IMO that puts your interests and that of your clients ahead of their own bonus structures).

Summary on variable loans

Variable loans are a good option to have in a policy. When buying a policy with a variable loan option, you can choose each year that you borrow from the policy whether to use the variable option or the fixed wash-loan option. The more options the better.

Also, if you want to protect yourself when purchasing cash value policies, it is recommended that you consider using an EIUL policy that allows you to move your money when in the borrowing phase to the 140% crediting method.