THE COMPASS

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The Million Dollar Mistake

Life insurance policies are sometimes sold for cash accumulation purposes to provide supplemental retirement income to the policyowner. By minimizing the face amount and maximizing the premium, it is possible to show a policy projecting a substantial amount of cash flow at retirement. What makes this attractive is that under current law, as long as the policy is not classified as a modified endowment contract, the policyowner can receive this supplemental retirement income from the policy income tax free.

The cash flow from the policy will be income tax free as long as the policyowner withdraws to basis and then begins borrowing from the policy, or only takes the income by borrowing. To qualify, the policy must remain inforce and mature as a death benefit upon the death of the insured; otherwise, if the policy is surrendered or allowed to lapse, the borrowed amount becomes taxable to the extent the cash value exceeds the owner’s basis in the contract.

A Taxing Example

Let’s assume that Mike York purchased his life insurance policy when he was 40 years old. His premium was $5,000 per year and to maximize the cash accumulation, he purchased the minimum face amount without creating a modified endowment contract.

Now age 65, Mike is ready to retire and begin using the cash value of the policy to supplement his income. The cash value of his policy has accumulated to $326,416. His cost basis for the 25 years is $125,000, making his gain in the policy $201,416. However, as long as he takes loans from the policy and does not withdraw any of the gain, Joe should be able to supplement his retirement income without paying any taxes on the loans he takes from the policy each year.

Working with his agent, Mike was able to determine that based on the age 65 cash values and by projecting the policy performance into the future, the policy could provide him an annual income of $35,717 using a variable interest rate loan between the ages of 65 and 90. The projection showed that he would still have a cash value of $205,918 at age 90, and a cash value of over $1.3 million at age 100. After looking at the numbers, Mike decided to round up the income to $36,000 per year.

The Expensive Mistake

Mike took his $36,000 annually and was able to live comfortably in his early years of retirement. But at age 87, Joe’s golden retirement years came to an end because his policy ran out of cash value and lapsed. Not only did Mike’s additional income stop, but a short time later he received an IRS Form 1099 from the insurance company saying he had reportable income of $1,003,680.

How could he have this much reportable income? At age 65, the gain was a little over $200,000 and he only took a total of $792,000 from the policy. As mentioned previously, whenever a policy lapses with a loan outstanding, the borrowed amount becomes taxable to the extent it exceeds the owner’s basis.

Since Mike allowed the loan interest to accrue each year as he took the income, his total loan at the time the policy lapsed was actually $1,128,680. After subtracting the cost basis of $125,000, he had a gain of $1 million, which became reportable income when his policy lapsed. AN EXPENSIVE MISTAKE!

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Life Protector Rider

Aviva's Life Protector Rider would have prevented Mike's policy from lapsing, and potentially saving Mike several thousand dollars in taxes. When the Life Protector Rider is attached to a policy, it causes the policy to have a reduced death benefit net of the loan. While the loan stays in place, all activity related to the loan, including the ability to take future loans, ceases. The outstanding loan will be automatically changed to a fixed interest loan if it is not already using that loan type. Essentially, the death benefit becomes the remaining cash value, plus a death benefit corridor. For the Life Protector Rider to activate, the policy must have been inforce at least 15 years and the insured must be at least 75 years old. For policies using the guideline line premium test, the rider will be activated when 95.5% of the cash value has been borrowed. At that time, a onetime charge of 4% will be made against the remaining cash value. This onetime charge is the only cost of the rider.

When policies use the cash value accumulation test (CVAT), the Life Protector Rider will activate when 87.5% of the policy cash value has been borrowed and the onetime charge will be 12%. The CVAT is an option that can be chosen in lieu of the guideline premium test for a policy. Although the Life Protector Rider helps protect the policyowner from incurring unwanted income taxes in the event the policy should lapse from over-borrowing, it is still in the best interests of the owner and beneficiary to manage the amount borrowed each year in such way as to keep the policy inforce and avoid lapse. For example, if Mike's policy had the Life Protector Rider, it would not have lapsed. However, his planned income stream would still have been shortened by three years and the death benefit payable to his beneficiary would have been substantially reduced.

Additional Actions to Prevent Policy Lapse

In addition to the Life Protector Rider, actions that could help keep the policy from lapsing include:

1. *At retirement, run an inforce illustration to determine what income stream the policy could support.*
2. *When the income amount is determined, reduce it slightly. Remember in Mike's case, he increased it slightly.*
3. *If a variable interest rate loan is chosen, illustrate a loan interest rate higher than the current rate.*
4. *Use an alternate interest crediting rate that is lower than the illustrated rate.*
5. *Adjust the income stream periodically by preparing inforce illustrations to determine how much income the policy can continue to support going forward. These adjustments could be up or down depending upon the performance of the policy.*

It's critical that both agent and client understand that the illustrations are projections. Pushing the envelope on projected cash accumulation or cash flow is a dangerous prospect, attempting to push the accumulation and cash flow even more so. Clients are best served by realistic projections that allow them to plan accordingly to their needs. Unrealistic projections may lead to problems for both the client and the agent in the future.

If Mike's agent had followed any one or more of these actions, his policy would have likely remained inforce. In any event, if the Life Protector Rider had been on Mike's policy, it would have prevented him from incurring a reportable income of over $1 million at age 87 when his policy lapsed.

This unique rider is designed to protect the policyowner from incurring unwanted reportable income if he/she plans on borrowing extensively from the policy. Therefore, whenever a policyowner is expected to use the policy for supplemental income, the Life Protector Rider should be added, when available, to protect against unwanted taxes.

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