The Pitfalls of Policy Loans

Out-of-control policy loans can erode a life insurance policy over time, eventually draining all the death benefits as well as saddling the policyowner with a substantial tax bill.

By Anthony Steuer

Life insurance policies have evolved from a simple method of sharing risk to complex financial instruments. Policy loans are one of the most complex, misunderstood and misused components of a life insurance policy. They are like termites, and if left to their own devices, they eventually will cause an insurance policy to collapse on itself. This could result in the insured having no coverage and, possibly, a huge tax penalty.

The term "policy loan" is a misnomer, according to Law and the Life Insurance Contract by Muriel Crawford and William Beadles. A loan is defined as the transfer of money by one person-the creditor-to another person-the debtor-upon agreement that the debtor will return to the creditor an equivalent sum at a later date, usually plus interest. A policy loan is not truly a loan, because the policyowner does not agree to repay the money transferred to him or her by the insurer, although interest is still charged. It is an advance of money that the insurer eventually must pay out under terms of the policy. Thus, a policy loan does not create a creditor-debtor relationship between the insurer and the policyowner.

U.S. Supreme Court Justice Oliver Wendell Holmes came to the same conclusion in Board of Assessors vs. New York Life Insurance Company, one of the leading court decisions involving policy loans. "The so-called liability of the policyholder never exists as a personal liability, it is never a debt, but is merely a deduction in account from the sum the plaintiffs (the insurer) ultimately must pay," the justice wrote in 1910.

Policy loans are more complicated than agents sell them to be, with promises of premium-free life insurance. In reality, borrowing to pay premiums reduces the death benefit. Some companies today even suggest to clients with underperforming policies that a policy loan could support their faltering policy. But this robs Peter to pay Paul, and the policyowner eventually must make up the difference.

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Let's look at a recent case. As part of a divorce settlement, a woman owned a life insurance policy that had been issued to her ex-husband in 1967. At the time of issue, the insured was 38. The policy was a whole life paid up at age 90 with a death benefit of $100,000. But before the policy had been transferred to the woman, a policy loan had been taken out on the policy.

In 1999, the policy had an outstanding loan of $62,098.42, with an interest rate of 5%. The policy's basis (the sum of premiums paid minus the sum of any dividends received in cash or credited against the premiums) at the time was $59,018, and the net surrender value was $947.43. The policy had reached a point at which it was "overloaned," which means the woman could no longer borrow against the policy to pay the premiums and loan interest.

The policyowner had received a bill of $2,949.67 for loan interest due, and the annual premium due was $2,152. This meant that there was an annual cost of $5,101.67 to carry a policy with a net death benefit of $37,901.58 (original death benefit of $100,000, less the outstanding loan balance of $62,098.42).

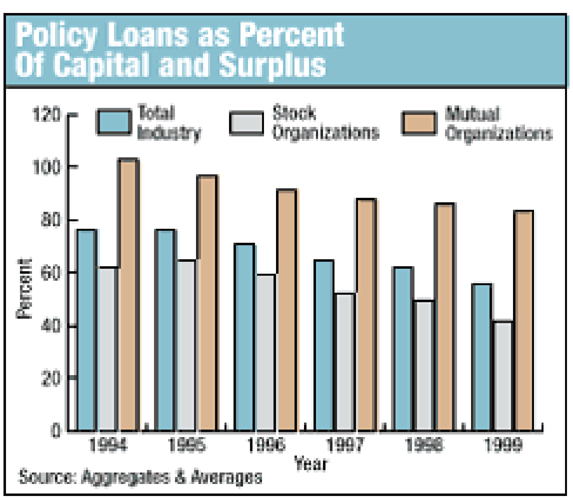
The policyowner had a few options. She could pay the $5,101.67 to keep the policy in force. Surrendering the policy and collecting the $947.43 would have resulted in a taxable gain of $4,027.85. This taxable gain is calculated by taking the gross proceeds (the net surrender value of $947.43, plus the outstanding loan of $62,098.47) and subtracting the basis of $59,018. In this scenario, the policyowner would have had to pay $1,611.14 in income taxes (in the 40% total tax bracket), and she no longer would have the benefit of the life insurance policy.

Another option was to take extended term life insurance in the amount of the original policy's current net benefit ($37,901.58) for about 12 months or to take a reduced paid-up policy with a death benefit of $3,399. She chose to take the reduced paid-up death benefit, which means there are no further premiums or interest due.

The situation above is quite common. The tax ramifications for this woman were minimal. Others do not fare as well. (See "Policy Loans Are Not Tax-Free")

Law and the Life Insurance Contract addresses the potential tax pitfalls for which life insurance policyholders must be on the lookout. The book specifically mentions minimum deposit insurance plans, which are financed through payments-either out-of-pocket or with a policy loan. "Minimum deposit insurance plans can constitute an unexpected `tax trap' for the ill-informed or just unlucky," the book states. "These potential pitfalls suggest that financing life insurance should be approached only with the greatest of care. Even then, it is risky and subject to factors beyond the insurer's and policyowner's control."

Here is an example that illustrates this "tax pitfall": a 31-year-old man whose father had bought him a financed (minimum deposit) policy with a death benefit of $150,000 when the insured was 4 years old. The man's father was the original owner, and ownership was transferred to the insured on his 21st



birthday. The man's father remembered that the agent who sold the policy had told him that after the initial payment, the policy could be put on automatic premium loan. There would be no further premiums or other costs to be paid, the agent had said, and there always would be a fully paid-up death benefit of $150,000. This was simply not true, even though the policy had been sold on the basis of its being a fully guaranteed policy.

The situation was dire. The policy loan was up to $70,327.83, and with dividend additions, the gross death benefit had grown to $184,300.17. A problem was revealed, however, when it was discovered that the net cash value was $74,600.61. This was the maximum allowable loan on the policy. But at the next renewal, the loan would increase to $75,414.72, so no further loan value was available. The insured received a bill for loan interest of $3,348.94, and because the premium was $1,515, his total annual out-of-pocket cost would be $4,863.94 for $185,000 of coverage.

This was not an affordable premium for this insured. But if he let the policy lapse, he would be smacked with a taxable gain of $39,247.41. There would have been a net surrender value of $5,352.98. Assuming that the insured was in a combined 35% tax bracket, he would have had to pay $8,383.61 for a supposedly paid-up-for-life policy.

The only way to forestall the policy from exploding was to surrender paid-up additions, which the carrier said would not lower the basis. Alternatives are currently being considered for this client.

How long will companies continue to lure life policyholders with the promise of something for nothing? As these examples demonstrate, a policy loan can be a time bomb in a life insurance policy. And as with any type of bomb, if not defused correctly, it can be disastrous. That ticking sound you hear is all the policy loans out there just waiting to explode.

Policy Loans Are Not Tax-Free

The Tax Reform Act of 1986 magnified the tax ramifications of policy loans and added new penalties, making this area even more complex.

Consider the so-called minimum deposit life insurance plans. Before the passage of TRA '86, interest due on loans to finance these types of life insurance policies sold after March 1, 1954, was not tax deductible.

This was further expanded under Internal Revenue Code Section 264(a)(3), which states, "a deduction is denied for interest paid on an indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract...pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of (sic) part of or all of the increases in the cash value of such contract either from the insurer or otherwise."

This rule (also referred to as the plan-of-purchase rule) applies only to contracts issued between Aug. 6, 1963, and the implementation of TRA '86 and contains four exceptions. If a financed plan met at least one of these exceptions, interest was deductible. A simplified explanation of these exceptions follows. For more detailed information, check the full version of the Internal Revenue Code.

The four-out-of-seven rule. This provides that interest on a financed plan is tax deductible if no part of (at least) four of the first seven annual premiums of a policy is paid through borrowing, either from the policy or elsewhere. A new seven-year period begins if a "substantial increase in borrowing occurs." If borrowing in any year exceeds the premium for that year, the excess is considered to be borrowings used to finance the previous year's premium. If the policyowner borrows an amount that exceeds the total of three years' premiums, then the four-out-of-seven rule has been violated, irrespective of when the borrowing occurred during the period. Once the seven years have passed, it appears that borrowing beyond that period could be at any level. This was the most commonly used exception.

The $100 exception. The interest deduction will be allowed for any taxable year in which the interest in connection with any systematic plan of borrowing does not exceed $100. Where such interest exceeds $100, the entire amount of interest (not just the amount in excess of $100) is nondeductible under Internal Revenue Code Section 264(a)(3).

The unforeseen-events exception. If the indebtedness is incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in the taxpayer's financial obligations, the deduction will be allowed under this rule, even though the loan is used to pay premiums on the contract. An event is not "unforeseen," however, if at the time the contract was purchased it could have been foreseen.

The trade-or-business exception. If the indebtedness is incurred in connection with the taxpayer's trade or business, the interest deduction will not be denied. Thus, if an insurance policy is pledged as part of the collateral for a loan, the interest deductions will come within this exception if the taxpayer can show that the amounts borrowed were actually used to finance the expansion of inventory or other similar business needs.

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