

Cashing In Your Life Insurance Policy

by *DenverPost.com*

In tough economic times, people are sometimes left scrambling for cash to meet everyday expenses and lifestyle demands. Your life insurance policy is a possible source of funds - but should you tap into it? There are certainly some drawbacks to using life insurance to meet immediate cash needs, especially if you're compromising your long-term goals or your family's financial future. Nevertheless, if other options are not available, life insurance, especially cash-value life insurance, can be a source of needed income. Life insurance, such as whole life and universal life, builds reserves through excess premiums plus earnings. These deposits are held in a cash-accumulation account within the policy. Cash-value life insurance offers the opportunity to access cash accumulations within the policy either through withdrawals, policy loans, or partial or full surrender of the policy. Another alternative involves selling your policy for cash, a method known as a life settlement. Be sure to bear in mind that although cash from the policy might be useful during stressful financial times, you could face unwanted consequences depending on the method you use to access the funds.

Withdrawals Generally, it is possible to withdraw limited amounts of cash from a life insurance policy. The amount available differs based on the type of policy you own and the company issuing it. The main advantage of cash-value withdrawals is that they are not taxable up to your policy basis, as long as your policy is not classified as a modified endowment contract (MEC). However, cash-value withdrawals can have unexpected or unrealized consequences:

1. Withdrawals that reduce your cash value could cause a reduction of your death benefit - a potential source of funds you might need for income replacement, business purposes or wealth preservation.
2. Cash-value withdrawals are not always received income-tax free. For example, if you take a withdrawal during in the first 15 years of the policy and the withdrawal causes a reduction in the policy's death benefit, some or all of the withdrawn cash could be subject to taxation.
3. Withdrawals are treated as taxable to the extent that they exceed your basis in the policy.
4. Withdrawals that reduce your cash surrender value could cause your premiums to increase in order to maintain the same death benefit; otherwise, the policy could lapse.
5. If your policy has been classified as an MEC, withdrawals generally are taxed according to the rules applicable to annuities - cash disbursements are considered to be made from interest first and are subject to income tax and possibly the 10% early-withdrawal penalty if you're under age 59.5 at the time of the withdrawal.

Loans Most cash-value policies allow you to borrow money from the issuer using your cash-accumulation account as collateral. Depending on the terms of the policy, the loan might be subject to interest at varying rates; however, you are not obligated to financially "qualify" for the loan. The amount you can borrow is based on the value of the policy's cash-accumulation account and the contract's terms. The good news is that borrowed amounts from non-MEC policies are not taxable, and you don't have to make payments on the loan, even though the outstanding loan balance might be accruing interest. The bad news is that loan balances generally reduce your policy's death benefit, meaning your beneficiaries might receive less than you intended. Also, an unpaid loan that is accruing interest reduces your cash value, which can cause the policy to lapse if insufficient premiums are paid to maintain the death benefit. If the loan is still outstanding when the policy lapses or if you later surrender the insurance, the borrowed amount becomes taxable to the extent the cash value (without reduction for the outstanding loan balance) exceeds your basis in the contract.

Policy loans from a policy that is considered an MEC are treated as distributions, meaning the amount of the loan up to the earnings in the policy will be taxable and could also be subject to the pre-59.5 early-withdrawal penalty.

Surrender In addition to withdrawals and policy loans, you can surrender (cancel) your policy and use the cash any way you see fit. However, if you surrender the policy during the early years of ownership, surrender fees will likely be charged by the company, reducing your cash value. These charges vary depending on how long you've had the policy. In addition, when you surrender your policy for cash, the gain on the policy is subject to income tax, and if you have an outstanding loan balance against the policy, additional taxes could be incurred. Although surrendering the policy can get you the cash you need, you're obviously relinquishing the right to the death-benefit protection afforded by the insurance. If you want to replace the lost death benefit later, it might be harder or more expensive to get the same coverage.

Life Settlement This concept is fairly simple. As the policy owner, you sell your life insurance policy to an individual or a life-settlement company in exchange for cash. The new owner will keep the policy in force (by paying the premiums) and

reap a return on the investment by receiving the death benefit when you die. Most types of insurance are eligible for sale, including policies with little or no cash value, such as term insurance. Generally, to qualify for a life settlement, you (the insured) must be at least age 65 years old, have a life expectancy of 10 to 15 years or less, and a policy death benefit of at least \$100,000 (in most cases). The primary advantage to a life settlement is that you can potentially get more for the policy than by cashing it in (surrendering the policy). Although there is little definitive information on the taxation of life settlements, the general treatment is that gain in excess of your basis in the policy is taxed to you as ordinary income. Although life settlements can be a valuable source of liquidity, consider the following issues:

1. You're giving up control of the death benefit.
2. The new policy owner(s) will have access to your past medical records and usually the right to request updates on your current health.
3. The life-settlement industry is very marginally regulated, so there's no guidance as to your policy's value - it's hard to determine whether you're getting a fair price for your policy.
4. Aside from the tax liability you could face, life settlements usually come with a cost - as much as 30% of your proceeds could be paid in commissions and fees, which reduces the net amount you receive.

Conclusion Poor economic times can prompt you to contemplate liquidating assets for cash. Sometimes you might have no other choice, but when it comes to life insurance, think about why you purchased the policy in the first place. Do you still need the coverage? Are the policy's beneficiaries depending on the death benefit if something happens to you? You should also consider other alternatives before using your life insurance policy for cash. Some options might include borrowing against your 401(k) plan, or taking out a home-equity loan. Short of hitting the lottery, none of these options comes without mitigating issues, but based on your current needs and financial circumstances, some choices might be better than others.

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