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Using cash value insurance

Policies, jilted for term life, still provide financial planning benefits

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NEW YORK (CNNfn) - In a market driven by double-digit returns and high-stakes investment strategies, the cash value life insurance plan has become the forgotten stepchild of financial planning tools.

Armed with a nod from professional advisers and their own heightened threshold for risk, many investors of late have opted instead to purchase term life insurance policies for less -- and invest the difference in stocks.

Buy term and invest the difference. It's a game plan that has served the public well for the better part of this decade. But some veteran financial planners say with rising interest rates and concerns of a stock market correction, it may be time to revisit the versatile – albeit costly – cash value policy once again.

Considering the tax benefits, loan provisions and earnings guarantees these policies provide, it can't hurt to take a look.

"There's no one answer for everyone, but my feeling is that most people have a need for both term and cash value life insurance," said Malcolm Greenhill, a certified financial planner with Sterling Wood Financial in San Francisco. "Term life insurance is so cheap these days that there's no reason not to."

Cash value

Permanent, or cash value, life insurance plans provide coverage for the full death benefit – ensuring the policy holder's beneficiaries will receive a lump sum upon his or her death.

Today, there are three main types of plans dominate the cash value arena: whole life, universal life and variable life. All three use part of the policy holder's premiums to pay for death benefit coverage and part to invest in securities on their behalf.

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In addition to your death benefit, the whole and universal policies guarantee a baseline interest rate on that investment regardless of market conditions. So, even if your investments yield negative earnings, many companies promise clients they'll still receive at least 3.5 percent to 4 percent in interest.

Variable life insurance is a little different. The premiums in these policies are invested in both the death benefit and in separate equity subaccounts that act much like a mutual fund.

They're a bit more risky since there are no guarantees, but they do allow for Wall Street-like returns.

The earnings in all three cash value policies grow tax deferred. Likewise, all three enable you to borrow or withdraw from the amount of cash value or investment earnings you've accrued. If you play by the rules of the Internal Revenue Service, that loan is considered tax free.

And in this corner...

By far, though, the most popular life insurance policy these days is term life insurance.

These policies insure an individual for a specific number of years -- many policies are purchased for 5,10 or 20 years of coverage.

Because they don't invest the premiums in equities, you won't accrue a cash value from which to borrow or withdraw. They're purchased strictly for the death benefit security, rather than an investment objective.

Term life insurance, however, also costs significantly less than cash value plans. A 50 year old man buying $750,000 worth of term life insurance for 10 years, for example, might pay $1,000 a year in premiums.

Under a cash value plan, that same man could pay $10,000 a year -- or more.

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-- Jack Dolan, ACLI

Easy way out

"I think the 'buy term and invest the difference' theory is an easy way out these days" said Jim Barnash, a certified financial planner in Chicago. "Part of that is because too many planners are turning into investment advisers and forgetting about financial planning."

He admitted the sales pitch for cash value life insurance lacks the glamour of a mutual fund or promising new upstart stock issue, but said they're also the only estate planning tool out there that provides a combination of death benefit security, interest rate guarantees and tax free loan provisions.

And don't forget, he said, that the earnings in your cash value plan grow tax-deferred.

"It's like taxes, it's not a real exciting topic at cocktail parties," Barnash said. "But there are a lot of creative things you can do with life insurance."

Cash value

For starters, he said, you can borrow against that cash value to pay off your mortgage, credit card debt or your child's college education. Better yet, you can secure that loan on a "tax preferred" basis.

Here's how it works: The IRS allows you to withdraw up to thè basis value of your policy -- or the amount you've put in through premium payments -- without incurring a taxable event.

So, if you've contributed $10,000 to the policy over the years, you're allowed to take out that much tax free. Some insurance companies will charge you a nominal, usually 2 percent, administrative fee for arranging the loan -- but others don't charge a thing.

Beyond that, it gets a little tricky. If that $10,000 you contributed has actually earned an extra $5,000 through investments, you'll have to think twice about whether it's worth it to dip in.

If you do decide to withdraw that sum, the IRS is going to want its share -- that's because the earnings were left to grown untaxed. That $5,000, if you take it out, will be taxed as ordinary income.

The best part about the loan provision, however, is that you never really have to pay it back. If, upon your death, you haven't met your loan obligations, the difference will simply be deducted from your death benefit.

Jack Dolan, a spokesman for the American Council of Life Insurance, said one of the most

common reasons for dipping into cash value policies is an unexpected emergency – such as medical bills or the sudden loss of pay.

"They can be used for any kind of emergency," he said.

Some, he said, also choose to surrender their policy and cash out, rather than taking a loan.

"After 30 years of paying premiums, sometimes policy holders feel that their loved ones are no longer financially dependent and that the need for their life insurance ceases to exist," he said. "Some choose to surrender that policy and capture the accumulated cash value (in a check)."

That's considered an outright withdrawal and it means your beneficiaries will no longer receive a death benefit down the road.

Using those proceeds, however, Dolan said many people choose to turn it into an annuity, invest it in stocks or "throw a big party."

The substitute

Another rarely mentioned benefit of cash value plans, Barnash said, is their ability to take the place of money market funds and bond yields –whole and universal life plans in particular.

That's because these two plans offer interest rates that largely mirror those of certificates of deposit, in the 6 percent range.

Since many financial planners allocate a portion of their clients' money toward cash or bonds, Barnash said, you could just as easily place your money into a life insurance plan that will solve the dual problem of providing death benefits and guaranteed earnings.

"From an investment standpoint I could do the same thing with life insurance that I could do with a municipal bond account, because if I'm getting a 5 percent tax deferral and I'm in the 28 percent federal tax bracket, I'm really getting the equivalent of almost 7 percent on a taxable yield," he said.

Obviously, he noted, buying cash value plans aren't the solution for everyone. But if you're buying term life insurance anyway, and investing the difference in a combination of stocks, money market funds and bond accounts, he said, you may want to look at cash value instead.

Barnash noted he usually recommends universal life insurance plans because of their flexibility.

"It's really term life insurance with a side fund that acts like a money market fund," he said. "It has a set interest rate that tracks the markets."

They also generally pay between one-half and one percentage point above a one-year CD, which is roughly 6 percent today.

Estate planning

There's one other way your cash value policy can benefit you and your loved ones.

If you set up the policy so that your child is the rightful owner, you'll help keep more of your estate out of the hands of the IRS when you die.

For example, if you leave your children with a $5 million estate, they would normally be required to pay up to 55 percent, or $2.6 million, in federal estate taxes once they inherit. If the life insurance policy is in their name, however, they can simply dip into your death benefit to help pay for those taxes –

and they'll be able to do so tax free.

Had you put the policy under your name, the death benefit would simply be added to the total estate value, and the whole thing would have been taxed.

Greenhill said he recommends to clients a combination of both term and cash value plans, as he did, to cover their bases.

Many people purchase term life insurance while they're younger, to provide for their family in the event of their untimely death. Many purchase term policies that cover them until the kids leave home, or until their mortgage is paid.

They then usually have a second cash value policy that provides both investment benefits and death benefits for their family, regardless of when they pass away.

"There's no simple answer on life insurance," Greenhill said. "Everything depends on the context of what the clients needs and objects are. If someone has the need for life insurance, where the death benefits will actually be paid, even if they're 90 years old, then cash value is really the only effective and only practical way to go."

But if you only need life insurance during the short-term, he added, you'll need to ask yourself if it's worth it to spend the extra money on cash value. Keep in mind, too, though, that many people who buy term life insurance thinking they'll only need it for 10 years find that their needs suddenly change as they grow older.

By then, Greenhill said, it may be to late to convert to a cash value plan.

"The most important question to ask yourself is how long do you really need the insurance," he said.

Senior settlements

Lastly, there is such a thing called a senior settlement, where healthy older adults sell their policies to an independent third party in exchange for part of the death benefit sum upfront.

They act much like viatical settlements, which are arranged between terminally ill individuals and a third party, who pays the policy seller a percentage of the death benefit and collects the difference from the insurance company when the seller dies.

You should be aware though that by selling your policy, you may be forfeiting other rights and benefits, such as disability benefits, Medicaid and certain riders on your policy. Moreover, the proceeds of the settlement could be subject to creditor claims.

The National Viatical Association also notes that some or all of the proceeds of the senior settlement may be subject to federal income tax and state franchise and income taxes. The best way to find out what impact your settlement may have is to consult a tax adviser.

Blast from the past

Dolan of the ACLI said he believes cash value life insurance plans will come back into their own at some point in the not too distant future.

"We think investors are being blinded by double digit returns of the market and when it does return to more historic levels, (cash value) plans will become more popular again," he said.

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