3 Options for Dealing with Policy Loans

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While conducting a policy review, advisors may uncover an older policy that has accumulated considerable cash value from which a significant loan was taken. On many of the older policies, if the loan remains, it may cause the policy to lapse prematurely. Not only will the policy lapse, but in the event the loaned policy has a gain on it, there will be taxes due. In this scenario, there are 3 options:

1. **Do Nothing**. The client can take the chance that the policy may lapse and that taxes may be due, if there is a gain on the policy.
2. **Repay the Loan from Funds Outside the Policy**. If your client can pay the loan from funds that are not from the policy, this option may work. However, ongoing premium may be required after doing so.
3. **Exercise an IRC §1035 Tax-free Exchange to a Newer Policy and Retain Loan on New Policy**. In some cases, when structured properly, a 1035 exchange to a newer policy where the loan amount is maintained on the new policy may provide a higher death benefit and lower loan interest charges. The loan on the new policy likely will then need to be repaid at some point in the future. If the loan is repaid using 'out of pocket' funds, it can be repaid at

any time. However, if the intention is to use the cash values in the new policy to repay the loan, then the policyowner must wait at least two policy years before paying off the loan.

When your client has a loan on a life insurance policy, a tax-free 1035 exchange to a new policy may provide not only more life insurance coverage, but also potentially lower internal costs and loan interest charges. In addition, riders can be added to the new policy that may provide living benefits for the policyowner, such as the ability to accelerate the death benefit to cover chronic illness or long-term care costs.

Therefore, the benefits of exchanging an older policy with a new one include the following:

1. The new policy may provide a higher death benefit than the old policy;
2. The new policy may have an extended guarantee and additional riders that provide lifetime benefits to the insured, such as funds to cover chronic illness, long-term care or critical illness coverage; and
3. When properly structured, a 1035 exchange that includes the original loan allows the policyholder to avoid taxation on the gain or the loan.

Advisors and their clients should consider the following when executing a 1035 exchange of an older policy with a loan:

1. Surrender charges will likely apply– the earlier the loan is repaid using cash values– and as a result the death benefit also will be reduced. Ongoing premiums may be required.
2. If the loan is repaid before the 1035 exchange is executed, using the old policy's cash values, the client may incur taxes.
3. In many cases, it will be necessary for the policyowner to repay the loan in year 2, or as early as possible thereafter. If the loan is not repaid the policy's performance must be reviewed on an ongoing basis to ensure the policy does not lapse. If the policy is owned by a trust, gift taxes associated with repaying the loan must be considered.
4. Loan repayment is not automatic. It is imperative that the advisor monitors the policy loan and helps the policyowner initiate the process to repay the loan according to the carrier rules.
5. Gain on the policy must be determined by the carrier, not the advisor. In most cases, the policyowner will receive a 1099 from the carrier, on which the taxable amount will be included in box 2a.

Conducting a policy review can go a long way in helping clients course-correct life insurance coverage and addressing their changing needs over lifetime.

Click here for our policy review kit.