Loan Rescue Example

Life insurance policies designed to perform in a 1980s interest rate world face tough going in today's meager rate environment, and they simply weren't designed to adapt. Lower rates pressure the dividends and interest carriers can credit. Some clients adjust by using policy loans to continue paying contract premiums. Unfortunately, these loans can end up painting them into a tax corner **(*)**. Accumulating loan balances affect dividends and reduce death benefit.

Here's a real example. In 1986 Mr. Smith purchased a **whole life policy** with a total death benefit of $1,000,000, split 50/50 between permanent and term coverage. The cost of the term coverage increased every year. However, as dividends accumulated, they purchased "Paid-Up Additions" whose death benefit replace some of the term coverage, thereby reducing term costs.

Eventually, the term portion of coverage would be all but eliminated by Paid-Up Additions, which themselves generate dividends, eventually resulting in a self-supporting contract with low or no out-of-pocket costs.

Unfortunately, the carrier's dividend crediting rate has declined with interest rates. This has increased the "as sold" annual premium from $13,600 to $17,100, and that required premium will continue to increase to cover ever-increasing annual renewable term costs. The Paid-Up Additions have not allowed a reduction in term coverage to the extent initially envisioned [when interest rates were much higher].

Mr. Smith faces a continually increasing premium to support his $1,000,000 death benefit. In addition, he has resorted to policy loans to help pay the annual contract premium; whole life premiums cannot be skipped. To date, the contract has accrued some $200,000 of indebtedness, as recapped below.

Providing Mr. Smith remains insurable, a potential solution exists via a "loan rescue". The policy can be "rescued" via a concept known as a mirrored loan. Here's how it works:

1. Mr. Smith executes a tax-free exchange (§1035) to a flexible premium product, with the new carrier applying the full indebtedness on the former (whole life) policy to the new contract.

2. Beginning in policy year 2, Mr. Smith **withdraws** contract value and applies it to the policy's (carried-over) indebtedness.
    a. Unlike most traditional whole life contracts, universal life generally allows the owner to withdraw all of the contract fund, subject to surrender charges.

3. By the end of policy year 3, the contract indebtedness is completely paid off.

4. Mr. Smith resumes a level premium paying schedule beginning in policy year 4. **His payments are less than his payments under the old (whole life) contract.**

5. Mr. Smith enjoys the same $1,000,000 death benefit.

6. Assuming a 3.75% level annual policy crediting rate, the full coverage continues to Mr. Smith's age 101.

Former (Whole Life) Contract	
Gross Cash Value	$450,000
Indebtedness	(200,000)
Net Cash Value	$250,000
Cost Basis	$375,000

(*) Policies surrendered or lapsed with outstanding loans in excess of basis results in taxable income to the extent of the difference. This undesirable tax consequence can often be avoided via a successful 'loan rescue.'

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