WHY CONSIDER CASH VALUE LIFE INSURANCE

Life insurance is one of the best ways to help financially protect your loved ones when you pass away. But many policies offer another benefit—the ability to build "cash value" you can tap into during your own lifetime.

This cash value grows over time. Not only can it increase the policy's death benefit (the amount your beneficiaries would receive if you died), but it also provides a potential source of funds you can use for various needs, from college tuition to a down payment on a home. Here's what you need to know.

Building cash value

When you take out permanent life insurance, a portion of each premium payment you make pays for the death benefit. A separate portion funds your cash value, which grows over time.

With whole and some universal life policies, the insurance company also pays interest on your cash value at a fixed rate, allowing it to grow even more. Conversely, some policies credit your cash value based on stock market performance. For example, indexed universal life credits your cash value at a variable rate that coincides with the S&P 500® index of large-company U.S. stocks. Generally, these policies prevent your cash value from falling—but they also cap your potential gain in a given year. Also, cash value grows tax deferred. Because you don't owe taxes on your balance while it rises, your interest can compound: It can grow faster than it would if taxes were pulled from your balance.

Prudential does not provide tax or legal advice; please consult an independent tax advisor regarding your tax situation.

Key takeaways

- Permanent life insurance policies allow you to build cash value over time.
- As your cash grows, you can tap into it to help pay for any financial needs you may have.
- Withdrawals or unpaid loans reduce your policy's death benefit.

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Tapping your cash value

As your cash value grows, you can use it for any financial needs you may have. This includes home improvements, debt consolidation, large medical bills—or even paying the insurance policy's premiums.

Another common use for permanent insurance policies: Higher education. Parents often buy policies for their children when their children are infants—and when premiums are the lowest. As your child grows, those premiums—along with any interest the insurer pays—help build cash value, tax deferred. You can then pull money from the policy to cover college costs.

You have several choices for accessing cash value. Each has potential pros and cons, depending on your needs.

Withdraw from it

Withdrawing money from your policy (up to the cash value amount) is the easiest way to tap your cash value. But there are a couple of potential downsides.

For starters, any money you pull out will reduce your policy's death benefit. If you plan to use the policy as a financial safety net or to leave a legacy to your heirs, that can be a significant drawback.

Also, you could face taxes depending on how much you withdraw. Withdrawals come out of your "basis"—the amount of your cash value that came from premiums you paid—first. Money you withdraw up to that amount is tax-free because it's considered a return of your basis. But any withdrawals above that amount come from interest or investment earnings; they're subject to tax as ordinary income.[1]

For example, say you have a policy that's built up $100,000 in cash value. If $75,000 of that value came from your premiums (i.e., your basis), and the remaining $25,000 came from interest, you could tap up to $75,000 tax-free. But you'd owe income tax on any amount you withdraw above that.

[1] Withdrawals from policies that exceed federal tax law limits may be subject to less favorable tax treatment.

Borrow from it

Another way to access the cash value in your policy is by taking out a loan against it. This method has a few benefits. When you pay back the loan, you don't incur any taxes and the death benefit isn't affected. (But if you don't pay it back, your death benefit decreases by your outstanding loan balance, and the portion of the loan that includes gains will be taxed.)

As with most loans, you have to pay interest on the amount you borrow. The good news: The outstanding balance continues to earn interest from the insurer. For example, if you pay 5% interest on your loan and the insurer credits your cash value at 4%, it's like you're really paying only 1% in interest.

Even so, you need to be careful about the amount you borrow. If your loan balance plus the interest you owe exceeds the cash value, the policy could lapse: After a grace period, your coverage—and the death benefit—will end.

Pay your premiums

If you have a sufficient balance, you can use your cash value to pay the monthly premiums for your policy. This helps keep your policy from lapsing should you face financial hardship and have trouble covering your costs out of pocket.

The tradeoff: Depleting your cash value lowers your policy's death benefit.

Surrender your policy

As cash value grows, you can get funds by surrendering your policy. When you cancel your contract, you'll receive the cash value you've accumulated, minus any surrender charges that apply. Depending on the policy, surrender charges may apply if you've owned the policy for fewer than 10 to 15 years. The insurer may also subtract any outstanding loan balances and unpaid premiums.

If you surrender your policy, it will no longer be in effect. That means the insurer won't pay a death benefit to your heirs when you pass on.

Tax-wise, surrendering a policy is similar to making a withdrawal: The amount of your cash value that comes from premiums is considered your tax-free basis. Any amount beyond that typically triggers taxes at your ordinary rate.

Is a cash value policy right for you?

Whether permanent life insurance with cash value makes sense depends on your circumstances. Before choosing your insurance strategy, assess your family's needs and understand the pros and cons of these policies.

Pros

- **Flexibility.** Permanent life policies offer more financial flexibility than term policies. Should you face a large expense—planned or unplanned—you have a tax-deferred asset you can rely on. It can also serve as a college planning tool, providing a potential source of funds that grows over time.
- **Variety**. You can select from a range of products, including whole life and universal life, based on your needs and budget. What's more, you can choose a policy that offers fixed interest payments, or one that credits your cash value based on investment performance.
- **Growth.** Whole life policies offer fixed interest rates, which helps your cash value grow even during market downturns. If you're looking for greater growth potential and are willing to assume higher risk, indexed universal life policies are another option.
- **Certainty.** Unlike term policies that cover you for a set length of time, permanent insurance lasts for your entire life: As long as you pay the premiums, your beneficiaries will receive your policy's death benefit.

Cons

- **Cost**. Whole life premiums are typically more expensive than term life policies, which don't have cash value. Unless you can afford the higher premium, term insurance may be a better choice for your family.
- **Time.** Even with the interest credited to your policy, it can take years for your cash balance to grow large enough to provide a substantial source of funds. These products are best for preparing for long-term financial needs.
- **Complexity.** Permanent life policies tend to be more complex than term contracts. For example, they may have different rules about how interest is credited to your cash value.
- **Penalties.** They also typically have surrender charges if you discontinue your policy during the first few years. Before choosing a policy, understand and discuss the policy details with your insurance representative.

Buying a policy

Even if you get free or low-cost life insurance through your workplace, it may not be enough to meet your coverage needs. It also might not be portable—you might lose it if you leave your job, or you may have to pay more to keep it. And it might not offer anything beyond a death benefit.

Purchasing separate, permanent life insurance can be a good way to bolster your protection and take advantage of the cash value.

Of course, make sure doing so makes financial sense. Permanent policies usually cost more than term. But like most life insurance, the younger and healthier you are when you buy, the cheaper it will be.

Shop around for policies that offer the best combination of premiums and features for your needs. Also, the rules around tapping cash value vary by insurer, so make sure you understand a product before you buy. You can contact the insurance company directly or contact me directly.

And remember that any insurer is only as strong as its “claims-paying ability.” So, look for those with top ratings from A.M. Best, Moody’s, or Standard & Poor’s. A good score from these independent agencies indicates the insurer will have the resources to make good on its financial obligations—to you.

What you can do next

If you’re considering life insurance, familiarize yourself with the various types of policies to determine which one best suits your needs. (You might decide that term makes more sense than permanent, or vice versa—or opt for both to cover different goals.) An insurance agent can help you determine how a permanent policy—and the cash value it offers—can fit into your overall wealth management plan.

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