Episode #198: The Most Important Benefit When Accessing Cash in an IUL

Video Transcription

Hey, and welcome to another episode of "Money Script Monday." My name is Adam Reyna, and, of course, as always, we want to thank you for attending. What we're going to do today is talk about one of the most important benefits when accessing cash inside an IUL. So, what we'll do is we'll kind of frame the topic, and we'll talk about some taxes paid. We will also talk about the different ways to access cash in the IUL, and then we're going to look at a quick case study. With that said, let's get started.

The number over here might be pretty shocking to you, but did you know that the average American actually pays over $525,000 of taxes in their lifetime? Again, that's more than half a million dollars in taxes. The reason I bring that up is because, remember, IUL is one of the best if not the best cash accumulation tax-free tool, tax-free distributions via income, and tax-free transfer via the death benefit. If you need to know more about IUL, I really suggest you talk to your advisor and get some diversification in that portfolio because a lot of us end up having just tax-deferred accounts when we get to retirement. So, it's also good to have some tax diversification in there as well and then, of course, tax-free using IUL.

The taxes paid over a lifetime is pretty shocking, but the typical American on average on their earnings pays over $339,000 worth of taxes. Then you see your property taxes are pretty significant, the different sales, whether that be from appreciated stock or capital gains, and then, of course, your cars throughout your lifetime, which is one of the biggest purchases we make, has a pretty hefty tax bill. When you use IUL, we would, of course, like to lower some of those numbers going on a tax-free basis.

Let's talk about some of the different tax-free ways we can access cash inside the IUL. So, the first one is a withdraw. It's a pretty simple concept, but we want to mention that it's tax-free up to basis. What that means is whatever amount of premium you've paid into your policy, you can go in and withdraw that cash value tax-free up to that number. So, anything over and above the premium that you've paid in would be taxable, so you usually don't want to go over your basis when you're taking a tax-free withdraw. An important word there is the opportunity cost, because what happens when you've consumed money? What happens when you take a withdraw, and you go and buy a vehicle or spend it on vacation? That money is now consumed and gone forever. You're sacrificing the opportunity to earn interest on that money forever because it's now been consumed. What we'll talk about is ways that we can mitigate that.

The second way would be a wash loan. This is a loan that you'd be taking from the insurance company from your life insurance policy. There is minimal charges to it, but there is typically a charge, but the goal of the insurance company is to make it about a break-even or a wash loan. For example, you may pay 1% to borrow the money from your policy, so there would be a 1% charge, but they're going to turn around and credit your policy 0.85%, so you really just have a minimal cost on there, so it doesn't really accumulate too much loan interest. Could be very helpful if that is for you, but, again, you'll see that there is an opportunity cost to that as well because you've now taken that money out and it's no longer earning a rate of return or positive interest.

The final way is a participating index loan. The key words there is that it's participating. Okay? So, we want it participating in the index. What that means is we're again borrowing from the insurance company, and there would be an assigned loan rate to that. We'll talk about it in an example here, but the example we're going to use is a 5% loan rate. So that may seem a little bit high, so you would be paying 5% on that loan, but you notice that the word opportunity cost is not there on the participating index loan because we're actually going to be credited on the money that we are now consuming and using for retirement, supplemental income, or vacations. Our hope is to earn positive arbitrage on that money. The positive arbitrage means we're earning more than what we're paying on the loan rate and positive interest, therefore still seeing our account balance grow. So, again, the most important way when accessing cash is using that participating index loan so we can earn positive arbitrage.

Let's take a look at a case study here. So, the logistics are it's a male, 33 years old, paying $20,000 a year for 5 years, so all in $100,000 worth of premium. What we're going to do is just take a snapshot at age 88 and look at a couple different numbers here. By the time he turns age 88, he has a cumulative income or cumulative loan, which are essentially about the same thing. It's the amount of income you've taken plus the loan interest, and if you remember, it's a 5% cost, okay? By the time he turns 88 on $100,000 worth of premium, he's received about $980,000 of tax-free income, so a pretty significant number there. The longer you have these, the really, really high chance of great performance that you're going to get. Okay, so the $980,000 loan does have the 5% loan rate, which may seem a little bit scary, but our accumulation value...which you can think of this as your interest-earning account. What that is, is it's going to offer uninterrupted compounding interest. So, whenever we have interest, we want interest on the interest that we're earning, and we typically want it to go uninterrupted. Even though he's gotten $980,000 worth of income out of this policy, by the time he turns age 88, he's got over $2.1 million of accumulation value. Reason being is because the way he accessed that money was the participating index loan. Remember, even though you've got the money out of the policy and you're using it for lifestyle funding, retirement income, vacations, whatever you choose to use it for, the insurance company is still paying you a rate of return on that money like it never left the account. In this case, he's earning 6.9% every year on that accumulation value, uninterrupted and compounding, that's the key and really the accelerator inside the IUL.

Let's look at an example of positive arbitrage. Positive arbitrage is, of course, the difference between the amount you're paying for the loan and the interest earned in that given year. So the $980,000 cumulative policy loan at a 5% loan rate is $49,000 worth of loan interest. If that was just a straight loan that's not still earning a rate of return, yes, that would probably seem pretty high. But remember that full cumulative loan is actually still earning a rate of return inside the cumulation value of almost 2.1, and in this example, it's earning 6.9%. So, in that year, you earned $143,000 of interest on the total accumulation value. Simple math, what we do to determine our positive arbitrage is we subtract the loan rate and the loan interest from the positive arbitrage or the positive interest rate that year, and we earned a $93,000 positive arbitrage that year, positive interest credit. So, again, the most important benefit when accessing cash in the IUL is that your participating policy index loan is still earning that rate of return and your accumulation value is growing uninterrupted with compounding interest. So, I hope you understand why we really do like IUL when we're talking about a tax-free accumulation, distribution, and transfer vehicle. I hope this was helpful and I hope you have a great day.