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Liquid life insurance

Permanent life insurance often includes a savings component (cash value) inside the policy which grows tax-exempt. But many policyholders aren't aware they can access this cash during their lifetime.

There are various ways the policyholder can access this cash value:

1. Policy withdrawal
2. Policy loan
3. Collateral loan
4. Taking dividends in cash (for whole life only)

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Let's take a closer look at each option

Policy withdrawal

This is a contractual offer by the insurer where the policyholder can make a direct withdrawal from the cash value available in the policy; this is treated as a partial lapse. This impacts all values in the policy directly. For whole life, this will reduce the death benefit by more than $1 for every $1 withdrawn and funds cannot be re-deposited. With Universal Life, this is not the case; it's dollar for dollar and funds can be re-deposited. As well, the policyholder can access the cash values tax free when disabled[1]. Regardless of the product, when the cash value is less than or equal to the adjusted cost basis (ACB), the withdrawal is tax free.

Sun Life form 16B.

Policy loan

This is a contractual offer by the insurer where the policyholder can borrow up to 100% of the cash value available in the policy minus one year's interest at the current policy loan rate. The policy loan rate set by Sun Life is prime +2% which is reset annually on the loan anniversary (not when the prime rate changes). While a policy loan reduces the ACB by the amount of the loan, it does not increase the capital dividend account (CDA). When the loan taken is less than or equal to the ACB, then the policy loan is tax free. When the insured dies, the death benefit will first pay the policy loan balance and then the remainder is paid out to the beneficiary.

Sun Life form E80.

Collateral loan

This requires the policyholder to assign the policy's cash value as collateral to borrow from a financial institution and undergo financial underwriting. This can result in a better loan rate offered than the policy loan rate from the insurance company. However, there may be additional fees charged by the third party financial institution. These loans are currently tax free and don't impact the policy values. When the insured dies, the death benefit will first pay the loan balance and then the remainder is paid out to the beneficiary.

Whole life dividends in cash

This is a contractual offer by the insurer as a dividend option available to whole life policies only. Like the policy loan, the taxable portion is the amount of the dividend in excess of the ACB. By taking the dividend in cash, there's no purchase of paid-up additional insurance (PUA) and therefore the death benefit remains level. Note that switching back to PUA dividend option would require underwriting. When the cash dividend is less than or equal to the ACB, then it's tax free.

Sun Life form 16A.

[1] Check policy contract for disability definition.

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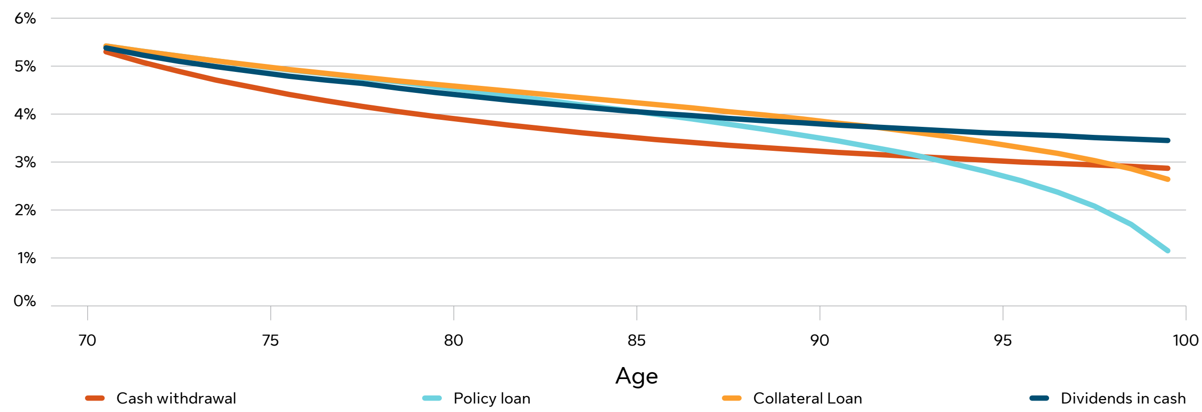
Case study

A 40-year-old male non-smoker purchases a $1M Sun Par Protector II paying base premiums of $30,295 for a guaranteed period of 20 years. He's looking for income to supplement his pension at retirement age 71 (until age 100). Let's look at the four ways he can access income using his participating policy assuming marginal tax rate of 50%.

	Cash withdrawal	Policy loan	Collateral loan	Dividends in cash
Loan rate		9.00%	7.00%	
Pre-tax max income (age 71-100)	$60,571	$28,938	$41,299	$45,287*
Average after-tax income	$32,840	$18,868	$41,299	$27,950
Average tax rate	46%	35%	0%	38%
Death benefit @ LE 90	$1,292,621	$1,917,103	$1,704,502	$1,920,345
Internal rate of return (IRR) @ LE 90**	3.25%	3.56%	3.90%	3.82%

*Average cash dividend over the 30 years. Par cash dividends increase each year and cannot be specified.
**IRR calculated using premiums paid, after-tax income taken, and net death benefit (after loan is paid, if applicable).

IRR on premiums paid, after-tax income and net death benefit



Let's look at the taxation of each option with an example

$20,000
Adjusted cost basis (ACB)

$100,000
Cash value (CV)

$30,000
Income taken

	Cash withdrawal	Policy loan	Collateral loan	Dividends in cash
When income taken is tax free	CV ≤ ACB	Loan ≤ ACB	Always	Dividend ≤ ACB
Formula for taxable portion	(CV – ACB) / CV × income	Loan – ACB	n/a	Dividend – ACB
Taxable portion	80% × $30,000 = $24,000	$30,000 – $20,000 = $10,000	n/a	$30,000 – $20,000 = $10,000

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Takeaway

Collateral loans are currently the most tax efficient way to access cash inside a permanent life insurance policy. As collateral loans are sensitive to loan rates and loan rates have increased since 2022, perhaps another option (if a whole life product is chosen) is to look at dividends paid out in cash. It's often not until near life expectancy that the Par cash dividends become taxable (i.e., when the cash dividends > ACB).

Reach out to your Sun Life sales representative to run our new **Access to cash values** Excel tool which summarizes the four options into one output summary.

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