Tax & Business Alert

AUGUST 2020

RISKS VS. BENEFITS OF LIFE INSURANCE LOANS

Because of the economic downturn triggered by the COVID-19 crisis, many people have found themselves in need of cash to pay unexpected medical bills, mortgage payments and other expenses. One option is to borrow against the cash value of a permanent life insurance policy, but such loans aren't risk-free.

RECOGNIZING POTENTIAL PITFALLS

Before you borrow against a life insurance policy, consider risks such as:

Reduced benefits for heirs. If you die before repaying the loan or choose not to repay it, the loan balance plus any accrued interest will reduce the benefits payable to your heirs. This can be a hardship for family members if they're counting on the insurance proceeds to replace your income or to pay estate taxes or other expenses.

Possible financial and tax consequences. Depending on your repayment schedule, there's a risk that the loan balance plus accrued interest will grow beyond your policy's cash value. This may cause your policy to lapse, which can trigger unfavorable tax consequences and deprive your family of the policy's death benefit.

Eligibility. You can borrow against a life insurance policy only if you've built up enough cash value. This can take many years, so don't count on a relatively new policy as a funding source.

TAPPING CASH VALUE

There can be advantages to borrowing from a life insurance policy over a traditional loan. These include:

Lower costs. Interest rates are usually lower than those available from banks and credit card companies, and there are little or no fees or closing costs. In addition, though you're not paying the interest to yourself, your interest payments may benefit you indirectly if your insurer distributes a portion of its profits to policyholders as dividends.

Simplicity and speed. So long as your insurer offers loans, there's no approval process, lengthy application, credit check or income verification. Generally, you can obtain the funds within five to 10 business days.

Flexibility. Most insurers don't impose restrictions on use of the funds. And you have the flexibility to design your own repayment schedule. You can even choose *not* to repay the loan, though that has negative tax consequences.

DISPELLING A MYTH

There's a common misconception that, when you borrow against a life insurance policy, you're "borrowing from yourself." In other words, when you pay interest on the loan, you're essentially paying yourself.

This may be true when you borrow money from a retirement plan, but it's not accurate when it comes to life insurance policy loans. In fact, you're borrowing from your insurer, pledging the cash value of your policy as collateral and paying interest to the company. Policy loans may be cheaper than traditional loans, but they're not free.

Generally no tax impact (as long as policy doesn't lapse). Funds acquired by borrowing from a policy aren't considered income, so they're typically not reported to the IRS. This differs significantly from *surrendering* a policy in exchange for its cash value, which triggers taxable gains to the extent the cash value exceeds your investment in the policy (generally, premiums paid less any dividends or withdrawals). Note that interest paid on the loan typically isn't deductible.

REVIEWING YOUR OPTIONS

Be sure you really need to borrow from a life insurance policy before doing so. Consider alternatives, such as selling an asset or reducing expenses. We can help you make the right choice. ■

IS YOUR PORTFOLIO READY FOR A REIT?

The stock market's roller coaster ride this year, spurred largely by the COVID-19 crisis, has many people craving stability. If volatility makes you nervous, it's important to maintain a diversified portfolio that won't plummet in value every time the Dow drops. One way to diversify your portfolio is with real estate.

This doesn't mean you need to go out and buy several apartment buildings or commercial properties and become a landlord. There's an easier, possibly less risky way, to gain real estate exposure — through a real estate investment trust (REIT).

SPECIAL ENTITIES

Although their name might imply it, REITs don't provide a direct investment in real estate. Instead, a REIT is a special kind of corporation that buys, sells and rents real estate on behalf of its investors. To qualify as a REIT, at least 75% of the company's income must come from real estate. Unlike normal corporations, REITs aren't required to pay taxes at the corporate level. In exchange for this benefit, they must distribute 90% or more of their rental income to shareholders in the form of dividends.

These property companies can be either private or publicly traded. Public REITs are like other public equities in that they trade on stock exchanges.

INCOME BOOSTER

Investors traditionally have turned to REITs to diversify their portfolios because they tend to perform differently from bonds and somewhat differently from the broad equity market, while generating long-term returns comparable to those of the latter. That said, the correlation between REITs and U.S. stocks has increased in recent years, which means that REITs may no longer provide quite the same diversification opportunities as in the past.

Many investors favor REITs for the securities' relatively large income stream. Individuals approaching retirement may look to REITs' dividends as a source of regular income. (But bear in mind that there's no guarantee that a REIT will distribute a dividend.) Liquidity is another important benefit, as REIT shares can be bought and sold on public markets. What's more, REITs give you flexibility to achieve your target real estate exposure because you can own the exact amount that fits your investment strategy.

There are drawbacks. For example, REIT dividends are taxed as ordinary income, which is subject to a higher rate than qualified stock dividends. But this could be mitigated somewhat because 20% of qualified REIT dividends may be available for the Section 199A qualified business income deduction. One way to limit REITs' tax impact is to hold them in an IRA, 401(k) plan or other tax-advantaged investment account.

WEIGH YOUR OPTIONS

There's no guarantee that REITs will appreciate or pay dividends. It's possible to lose money in such investments. Talk to a qualified investment advisor about whether a REIT might benefit your portfolio given your personal circumstances, long-term goals and risk tolerance. We can help you assess the tax impact. ■

TAKING DISTRIBUTIONS FROM YOUR TRADITIONAL IRA

Like many people, you may have worked hard to accumulate a nest egg in your traditional IRA. Knowing the finer points of the distribution rules is critical — particularly as some of these rules have temporarily changed under the Coronavirus Aid, Relief and Economic Security (CARES) Act.

EARLY DISTRIBUTIONS

The COVID-19 pandemic has caused many people to take or consider taking early IRA distributions. The CARES Act allows you to withdraw up to $100,000 on or after January 1, 2020, and before December 31, 2020, on a tax-advantaged basis if you meet one of various conditions related to the COVID-19 crisis — even if you're under age 59½.

If you qualify, the CARES Act waives the 10% early withdrawal penalty and allows you to spread the tax liability over three years. You can avoid tax by recontributing the withdrawn amount within three years (regardless of annual contribution limits in those years). We can help you determine whether you qualify.

REQUIRED MINIMUM DISTRIBUTIONS

People with traditional IRAs generally must begin taking annual required minimum distributions (RMDs) by April 1 of the year following the year in which they reach age 72 (70½ if you turned 70½ before January 1, 2020). RMDs are also generally required for inherited retirement accounts regardless of the heir's age (unless the heir is the original owner's spouse).

The CARES Act allows you to skip a 2020 RMD. Doing so can allow funds to continue growing on a tax-advantaged basis. Plus, if the values of investments in your account have declined because

of the economic downturn, taking a distribution means selling shares at a much lower price.

Remember, your RMD for 2020 is calculated based on the account's value as of December 31, 2019. If that value has declined, the RMD will represent a larger percentage of the account's total value than you originally anticipated. Skipping your 2020 RMD can enable you to maintain the account's value as much as possible for another year in the hope that investment values will improve in the future.

KEEP MORE MONEY

Prudently planning how to take money out of your traditional IRA can mean more money for you and your heirs. Contact us to review your account as well as to discuss any aspect of retirement planning. Finally, be aware that the CARES Act relief discussed here can also apply to many employer-sponsored retirement plans, such as 401(k)s. ■

WITH GLITCH FIXED, CONSIDER BUSINESS PROPERTY UPGRADES

When the Tax Cuts and Jobs Act was passed in 2017, it contained an inadvertent drafting error by Congress. The error made it so that any qualified improvement property (QIP) placed in service after December 31, 2017, wasn't considered eligible for 100% bonus depreciation. This typically includes upgrades to retail, restaurant and leasehold property.

As a result, businesses that owned the eligible property couldn't take advantage of the additional tax deduction of 100% of the cost of qualifying upgrades. The problem became commonly known as the "retail glitch."

Fortunately, when drafting the Coronavirus Aid, Relief and Economic Security Act, Congress fixed the glitch. Most businesses can now claim 100% bonus depreciation for QIP, assuming all applicable rules are followed. Better yet, the correction is retroactive to any QIP placed in service after December 31, 2017. (Improvements related to a building's enlargement, elevator or escalator, or internal structural framework don't qualify.)

Because of the slowdown in the U.S. economy, your business (like so many others) may not be in a financial position to undertake a QIP project right away. However, you may have made eligible improvements earlier this year or in earlier tax years after December 31, 2017. As economic conditions improve, factor this tax break into your considerations for making future property improvements. ■