How To Dump Your Whole Life Policy

[Editor’s Note 1/15/2018: The long-awaited White Coat Investor Online Course is live and is available for purchase here. The course is entitled: Fire Your Financial Advisor. No more wading through dozens of books at the library, scrolling through hundreds of blog posts on dozens of blogs, or checking in daily with online forums trying to gain a financial education the way the hobbyists do. This course will take you from feeling anxious and having no plan to having a written financial plan you can follow the rest of your investing career as a professional and a retiree. This course is the material that should have been taught to you in college, medical school, or residency, but never was.]

I discuss whole life insurance all the time on this blog. I don’t actually post about it all that much, but the comments on these posts number over 1000, and go on for years and years after the post is written. Most of the posts address whether or not you should buy a whole life policy (or its cousins, Universal Life and Variable Life). I generally recommend against them, and the insurance salesmen who love to post comments longer than the post itself not only recommend them, but feed their children and pay their mortgage from the commissions (50-110% of the first year’s premium) on the
sales. They’re not happy when WCI readers actually have responses to the myths they’re using to sell them. Today, however, I’m going to address a different question, and one that I get in my email box far more often from doctors.

Q.

If I am already in whole life for 7 years, what is the best way to proceed? It seems tough to just drop it, but at the same time also tough to keep paying in.

A.

Long-time readers will recall I was once the proud owner of a whole life insurance policy from Northwestern Mutual (NML). It was sold to me as a medical student by a very dear friend who happened to be interning with NML that summer. He subsequently went in to another line of work. The policy was terrible. It was completely inappropriate for me. What I really needed was a $1 Million 30 year level term policy. What I got was a convertible $280,000 term policy whose rates would go up every 5 years until long after I would be financially independent coupled with a $20,000 whole life policy. This tiny whole life policy was something like $21 a month. The annual policy fee was relatively huge compared to the premiums, not to mention the premiums were being paid on a monthly basis (even a poor medical student could have come up with $240 all at once if he had known it would improve returns.) The policy had a terrible return. After 7 years, I cashed it in for something like $1,100. I had paid in something like $21 * 12 * 7 = $1,764. That’s a loss of 38%, or something like -12% per year. It didn’t quite track the minimum guaranteed returns in the original illustration, but my returns were pretty darn close to the minimum and a long
way away from the projected illustration. The in-force illustration I obtained (just for fun) prior to surrendering it indicated I was still many years away from breaking even. For a few hundred dollars of ill-gotten profit, NML is partially responsible (along with a mortgage lender, a realtor, and a mutual fund salesman) for [unleashing The White Coat Investor on the world](#). I wonder how much they would love to pay now to get me to take down the whole life posts on this blog given that 80,000 people are coming here every month now, and the most popular posts are about whole life insurance. The question we will be addressing today, however, is not whether you should buy a policy. It is what you should do with the one you already have. There are a number of points to consider.

**Do You Want Or Need A Permanent Life Insurance Policy?**

Although 80% of those who purchase whole life policies eventually surrender them, there are a select few who want them, and even a tiny percentage who actually need them. If you are one of these people, you should keep your policy. Examples of people who need them include people who will never actually become financially independent (working until death) and will always have someone depending on their income financially. Someone with an estate tax problem AND a liquidity problem may also need a permanent life insurance policy. There are also some legitimate business issues that are best solved with these policies. Even if you don’t need a policy, you might want one. Perhaps you can’t stand the volatility of higher-returning investments like stocks or real estate. Or perhaps the 3-5% returns on the policy are adequate for your needs. Or perhaps you’re into the whole [Bank on Yourself/Infinite Banking](#) thing and love to borrow from yourself rather than a bank to buy expensive stuff. If any of this describes you, then you probably want to keep your policy. You might be able to improve it by paying annually,
changing dividends to offset premiums instead of paid up additions, or even by purchasing additional paid up additions, but you probably shouldn’t get rid of it.

**Keep It If You’ve Had It For a Long Time**

Whole life has low returns when held for decades. It has terrible returns if only held for a few years. That means that after a while, the returns GOING FORWARD aren’t actually too bad. The terrible returns are heavily front-loaded, and generally follow the period for which commissions are paid to the salesman. If you’re past those years, you probably want to keep the policy, even if you don’t like it. I think 15-20 years is about the turning point, but one could argue this occurs by year 10, or even sooner. It varies by policy and how much you hate it. Certainly you can’t argue it is a good idea to keep it just because you’ve had it for a year or two or five. If you don’t want to pay the premiums any more, then change dividends to offset premiums. If you just want to maximize the return, then purchase paid up additions up to the MEC limit and make sure you’re paying annually. If you don’t want to hire someone to evaluate the policy, this post may help you to [evaluate your own whole life policy](#).

**If You’re Going To Cancel, Do It Now**

Whole life insurance works out best when you hold it until death. Once you have decided you are going to drop it, there is no point in waiting a few more years until it breaks even or gives you a certain return you will feel good about. You may want to wait until just before your next premium is due if it means the cash value will be a little higher, but you certainly don’t want to pay more premiums on a policy you will drop at some point between now and your death.
Consider The Alternative

Remember that you cannot just consider the policy on its own merits. You also need to compare it to what you would do with the money if you were not using it for life insurance premiums. If you’re going to be using the money to max out a 401(k), or even better, get a match in a 401(k), then it is a no-brainer to get rid of it. Likewise if the alternative is something like maxing out an HSA or a personal or spousal Backdoor Roth IRA. If you, however, are comparing it to a taxable account, especially invested in low risk assets, or to just spending the money, then it will compare a little more favorably.

Get Term In Place First

It should go without saying that you should never cancel a permanent life insurance policy unless you already have sufficient term life insurance in place to meet your needs and wants. It usually only takes a couple of weeks to buy a term policy, but don’t leave yourself exposed even for that long. Besides, you might be surprised by something found during underwriting.

Don’t Worry About Tiny Policies

When you start talking about getting rid of a policy, the first thing to consider is about any possible tax penalties or tax benefits of doing so. For a teeny, tiny policy like the one I had, that just doesn’t matter much. My loss was only a few hundred dollars, and the tax benefit on that would be far outweighed by the hassle factor and the actual costs to claim that. If you have a tiny policy, just get rid of it. You may have had one of these purchased for you by your parents, who dutifully paid a few bucks a month on it for two or three decades before presenting all $2000 of cash value in it to you (and asking you to take over the payments.) Be sure to thank
them for their kindness, then cash it out and use the money to fund a Backdoor Roth IRA. You might not want to mention that you did that during Thanksgiving dinner, by the way.

**Evaluate Your Options Carefully On A Large Policy**

However, if you have paid tens of thousands of dollars in premiums, you probably want to spend a little more time deciding what you wish to do with this policy. If your policy has a large gain, you’ve probably had it long enough that you should keep it. But if not, you can avoid taxation of that gain (typically taxed at your regular marginal tax rate) by exchanging it into a better cash value life insurance policy, a very low cost variable annuity (VA), or even long-term care insurance. The best of those options, in my view, is generally the VA, since buying another cash value life insurance policy most likely entails a new commission, and most doctors ought to be able to self-insure any long-term care needs. If your main concern with investing in an insurance policy is the low returns available in whole life, you may be interested in a very low cost variable life insurance policy, but again, it might not be worth it because you’ll probably have to pay a new commission.

**Preserving Your Loss**

A much more likely scenario for someone who has only been paying premiums for a few years and now realizes he has bought a “pig in a poke,” is that you are way underwater on your “investment” at this point. Perhaps you’ve been paying premiums of $20,000 per year for five years, and now have a cash value of $75,000. You could just surrender the policy, take your $75K to invest elsewhere, and consider the $25K a “stupid tax.” Or, you could have Uncle Sam share your pain.

A great way to preserve this loss for tax purposes is to do a 1035 exchange. You must have at least $1 in surrender value to do this (so make a few more payments if you don’t have any cash value at all), but basically you exchange the cash value into a low-cost VA such as that offered by Vanguard (around 0.5% per year more than a comparable Admiral fund) or Jefferson National (no commission, just a fee of $20 a month). This exchange not only preserves the cash value tax-free, but also preserves the basis. You may then either let the VA grow until the cash value equals the basis, and then surrender the VA with no tax cost, or you may immediately cash out of the VA and book the loss. Life insurance losses aren’t tax deductible, but VA losses are. There is some debate as to whether those losses are deductible at your marginal tax rate or at the lower capital gains rate, but when an area in the tax code is gray, I prefer to call it in my favor. It would probably be wise to do the exchange and the surrender in different tax years to avoid concern about the step transaction doctrine. [Update 1/31/2017: There is no longer any debate on how to deduct this loss. Per IRS Publication 575, you take it on Schedule A (line 28). Here it is in IRS-speak:

“Losses. You may be able to claim a loss on your return if you receive a lump-sum distribution that is less than the plan participant’s cost. You must receive the distribution entirely in cash or worthless securities. The amount you can claim is the difference between the participant’s cost and the amount of the cash distribution, if any. To claim the loss, you must itemize deductions on Schedule A (Form 1040). Show the loss as a miscellaneous deduction subject to the 2% of-adjusted-gross-income limit.”]

[Update 4/19: You can no longer deduct these losses. Letting
the value of the VA grow back to the basis is your only option other than surrendering it and eating the loss.]

There are lots of options when you want to dump your whole life insurance policy. Spend time evaluating them or you may make another mistake almost as big as the one that got you into this mess. What do you think? Have you had this dilemma? How did you solve it? Comment below!