Equity Harvesting

This Module will cover the much-talked about and marketed concept of how clients can build wealth using the equity from their homes. Many readers will know something about this topic from Doug Andrew's book Missed Fortune 101 (which contains many half-truths). This Module will explain to readers in plain English what can and can't be done when implementing the Equity Harvesting concept. The material will point out the laws that govern this topic and will use "real world" numbers when illustrating how the concept can work well or not so well. This material is not "sales" material as you have read in for public books on this topic.

Introduction

Defining Equity Harvesting (EH)

The WPI defines EH as follows:

> ***EH is removing equity from a personal residence or commercial property through refinancing (or a home equity loan) where the money borrowed is placed in cash value life insurance.***

EH is done for two reasons.

1) To build wealth in a tax-favorable manner.

2) To asset protect the equity of the home or commercial property.

Reason number 1) is the main reason most people will use EH; and as a nice bi-product (when set up correctly), the client also can asset protect the home's equity and the removed equity.

Why is cash value life insurance used when repositioning the borrowed funds?

The answer is two fold:

1) Cash in a properly structured life insurance policy can **grow tax-free** and be **removed tax-free** (tax-free loans) (typically in retirement).

2) Properly structured cash-value life insurance policies have **minimum guaranteed rates of return** on the cash value in the policies so the policies mitigate investment risk (although the policies are not entirely without risk which will be discussed in the life insurance Module from this course).

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Why are advisors of all kinds now pitching the concept of EH?

First, it must be stated that the concept is almost universally pitched by life insurance licensed agents. The reason it has become so prevalent is due to life insurance sale's programs such as Circle of Wealth, LEAP, and books touting the concept such as Missed Fortune 101.

Advisors are NOT getting full disclosure on the pros and cons of EH.

As stated, no book or sale's program is giving advisors full disclosure on the concept of EH. This course material will, and readers will learn to look at all angles of EH when working with and disclosing important features of the plan to clients.

You will learn why the Alternative Minimum Tax needs to be dealt with for many clients who use EH.

You will learn all about how difficult it is to write off the interest on home equity indebtedness when the borrowed money is invested directly into a cash value life insurance policy.

Straight from the IRS

This material is going to do something you'll never see in public books covering EH or sale's programs. The material is going to cover the laws that govern this topic so you can know them, follow them, and give advice/full disclosure to your clients when discussing the concept of EH with them. The following is from an IRS web-site which summarizes IRC Title 26 Section 163.

The home mortgage interest deduction

As stated earlier, the concept of EH revolves around removing equity from a piece of property (for the rest of this material we will assume the property is a client's personal residence) and repositioning the borrowed funds into a tax-free retirement vehicle (cash value life insurance).

As you can imagine and as will be discussed in great detail later, the concept becomes much more powerful if you can write off the interest on the borrowed funds (meaning that the cost of borrowing funds is less than the actual interest rate due to the income-tax write off).

The ability of a client to write off the interest on a loan taken against their personal residence will depend on whether the debt is considered Home Acquisition Debt or Home Equity Debt. The IRS defines both as follows.

Home Acquisition Debt (HAD)

Home Acquisition Debt is a mortgage taken out after October 13, 1987, to buy, build, or substantially improve a qualified home (a main or second home). The debt must be secured by that home.

If the amount of the mortgage is more than the cost of the home plus the cost of any substantial improvements, only the debt that is <u>not more than the cost of the home plus improvements</u> qualifies as Home Acquisition Debt. The additional debt may qualify as Home Equity Debt (discussed later).

Home Acquisition Debt limit. The total amount you can treat as Home Acquisition Debt at any time on your main home and second home cannot be more than **$1 million** ($500,000 if married filing separately). This limit is reduced (but not below zero) by the amount of your grandfathered debt (discussed later). Debt over this limit may qualify as Home Equity Debt (also discussed later).

Refinanced Home Acquisition Debt. Any secured debt used to refinance Home Acquisition Debt is treated as Home Acquisition Debt. However, the new debt will qualify as Home Acquisition Debt <u>only up to the amount of the balance of the old mortgage principal just before the refinancing</u>. Any additional debt is not Home Acquisition Debt but may qualify as Home Equity Debt (discussed later).

Mortgage that qualifies later. A mortgage that does not qualify as Home Acquisition Debt because it does not meet all the requirements may qualify later. For example, a debt that is use to buy a home may not qualify as Home Acquisition Debt because it is not secured by the home. However, if the debt is later secured by the home, it may qualify as Home Acquisition Debt after that time. Similarly, a debt that is used to buy property may not qualify because the property is not a qualified home. However, if the property later becomes a qualified home, the debt may qualify after that time.

Mortgage treated as used to buy, build, or improve home. A mortgage secured by a qualified home may be treated as Home Acquisition Debt even if the proceeds are not actually used to buy, build, or substantially improve the home. This applies in the following situations.

1. The home is purchased within 90 days before or after the date the mortgage is taken out. The Home Acquisition Debt is limited to the home's cost plus the cost of any substantial improvements within the limit described below in (2) or (3). (See *Example 1*.)
2. A home is built or improved and the mortgage is taken out before the work is completed. The Home Acquisition Debt is limited to the amount of the expenses incurred within 24 months before the date of the mortgage.

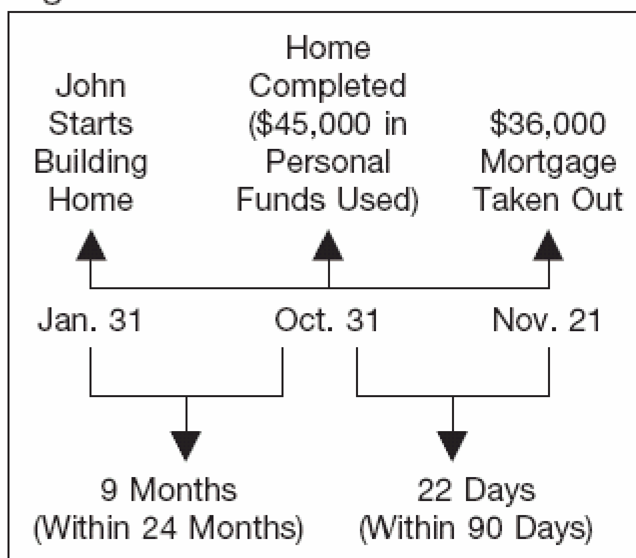
3. A home is built or improved and the mortgage is taken out within 90 days after the work is completed. The Home Acquisition Debt is limited to the amount of the expenses incurred within the period beginning 24 months before the work is completed and ending on the date of the mortgage. (See *Example 2*.)

Example 1.

You bought your main home on June 3 for $175,000. You paid for the home with cash you got from the sale of your old home. On July 15, you took out a mortgage of $150,000 secured by your main home. You used the $150,000 to invest in stocks. You can treat the mortgage as taken out to buy your home because you bought the home within 90 days before you took out the mortgage. **The entire mortgage qualifies as Home Acquisition Debt because it was not more than the home's cost**.

Example 2.

On January 31, John began building a home on the lot that he owned. He used $45,000 of his personal funds to build the home. The home was completed on October 31. On November 21, John took out a $36,000 mortgage that was secured by the home. The mortgage can be treated as used to build the home because it was taken out within 90 days after the home was completed. The entire mortgage qualifies as Home Acquisition Debt because it was not more than the expenses incurred within the period beginning 24 months before the home was completed. This is illustrated by *Figure C.*



Date of the mortgage. The date you take out your mortgage is the day the loan proceeds are disbursed. This is generally the closing date. You can treat the day you apply in writing for a mortgage as the date you take it out. However, this applies only if you receive the loan proceeds within a reasonable time (such as within 30 days) after your application is approved. If a timely application you make is rejected, a reasonable additional time will be allowed to make a new application.

Cost of home or improvements. To determine your cost, include amounts paid to acquire any interest in a qualified home or to substantially improve the home.

The cost of building or substantially improving a qualified home includes the costs to acquire real property and building materials, fees for architects and design plans, and required building permits.

Substantial improvement. An improvement is substantial if it:

- Adds to the value of your home,
- Prolongs your home's useful life, or
- Adapts your home to new uses.

Repairs that maintain your home in good condition, such as repainting your home, are not substantial improvements. However, if you paint your home as part of a renovation that substantially improves your qualified home, you can include the painting costs in the cost of the improvements.

Home Equity Debt (HAD)

If a client takes out a loan for reasons **other than to buy, build, or substantially improve a home**, it may qualify as Home Equity Debt. In addition, debt incurred to buy, build, or substantially improve a home, to the extent it is **more than** the Home Acquisition Debt limit (discussed earlier) may qualify as Home Equity Debt.

Home Equity Debt is a mortgage taken out after October 13, 1987, that:

- Does not qualify as Home Acquisition Debt or as grandfathered debt, and
- Is secured by your qualified home.

Example.

You bought your home for cash 10 years ago. You did not have a mortgage on your home until last year when you took out a $20,000 loan secured by your home to pay for your daughter's college tuition and your father's medical bills. This loan is Home Equity Debt.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Home Equity Debt limit. There is a limit on the amount of debt that can be treated as Home Equity Debt. The total Home Equity Debt on your main home and second home is limited to the smaller of:

- **$100,000** ($50,000 if married filing separately), or
- The total of each home's fair market value (FMV) reduced (but not below zero) by the amount of its Home Acquisition Debt and grandfathered debt. Determine the FMV and the outstanding home acquisition and grandfathered debt for each home on the date that the last debt was secured by the home.

Example.

You own one home that you bought in 1999. Its FMV now is $110,000, and the current balance on your original mortgage (Home Acquisition Debt) is $95,000. Bank M offers you a home mortgage loan of 125% of the FMV of the home less any outstanding mortgages or other liens. To consolidate some of your other debts, you take out a $42,500 home mortgage loan [(125% × $110,000) = $95,000] with Bank M.

Your Home Equity Debt is limited to $15,000. This is the smaller of:

- $100,000, the maximum limit, or
- $15,000—the amount that the FMV of $110,000 exceeds the amount of Home Acquisition Debt of $95,000.

Debt higher than limit. Interest on amounts over the Home Equity Debt limit (such as the interest on $27,500 [$42,500 - $15,000] in the preceding example) generally is treated as personal interest and is **not deductible**. But if the proceeds of the loan were used for investment, business, or other deductible purposes, the interest may be deductible. The limit on writing off interest if it qualifies as an investment is the income generated by the investment (which with a life policy is typically ZERO).

Part of home not a qualified home. To figure the limit on Home Equity Debt, you must divide the FMV of your home between the part that is a qualified home and any part that is not a qualified home.

Fair market value (FMV). This is the price at which a home would change hands between a seller and a buyer, neither having to sell or buy, and both having reasonable knowledge of all relevant facts. Sales of similar homes in your area, on about the same date your last debt was secured by the home, may be helpful in figuring the FMV.

Grandfathered Debt

If you took out a mortgage on your home before October 14, 1987, or you refinanced such a mortgage, it may qualify as grandfathered debt. To qualify, it must have been secured by your qualified home on October 13, 1987, and at all times after that date. How you used the proceeds does not matter.

Grandfathered debt is not limited. All of the interest paid on grandfathered debt is fully deductible home mortgage interest. However, the amount of your grandfathered debt reduces the $1 million limit for Home Acquisition Debt and the limit based on your home's fair market value for Home Equity Debt.

There is more to learn about grandfathered debt that has been omitted from this course material due to space issues. If you have a client who has grandfathered debt, please contact The WPI (info@thewpi.org) for further information you can read up on so you are giving accurate advice to the client.

What you need to know from the above information

1) If a married couple buys a new home, they can write off the interest on the mortgage taken out to purchase that home up to a $1,000,000 Home Acquisition Debt (HAD) limit.

Why is this important?

a) If your clients (married) buy a home where the loan is more than $1,000,000, they need to know that they will not be able to write off the interest on debt which exceeds $1,000,000 (most clients think that ALL home acquisition debt is deductible).

b) What’s equally important to understand is that, if a client sells a home that has significant equity and buys a new home where the new home has sizable debt, all of the interest is deductible up to $1,000,000 of debt.

Example.

Assume a married client has lived in a home for 10 years. The client bought the home for $400,000, paid off the debt on the home over the last 10 years, and is going to sell the house for $1,000,000 (after realtor fees).

IF the client then buys a new house worth $1.25 million and takes out a home loan for $1,000,000, all of the interest on the home is deductible.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Why is this important? As you read earlier, if the client wanted to implement an Equity Harvesting strategy using the current $1,000,000+ house with no debt, the interest deduction would be limited to $100,000 of Home Equity Debt. With this example, the client could sell the home, invest the $1,000,000 net proceeds anywhere (including life insurance), and buy a new home with $1,000,000 of debt and write off all the interest on the new home loan.

c) Following up on the previous example, it is vitally important to understand that on Home Equity Debt (HED) a client can only write off debt on the debt up to $100,000. Also, the HED cannot be deducted to the extent it exceeds the fair market value (FMV) of the home.

Example

Assume Dr. Smith (age 45) has a home that was purchased 10 years ago for $300,000. Today the home is worth $700,000, and the client has $200,000 of debt on the home. Assume Dr. Smith ran into an advisor who follows the Missed Fortune 101 approach to building wealth who tells him to refinance his home and remove $300,000 of equity for repositioning into a life insurance policy.

It is vitally important for the advisor to disclose to Dr. Smith that he will only be allowed to write off debt on $300,000 worth of the $500,000 debt because of the $100,000 limit on the deduction for Home Equity Debt.

It is also important to understand that, IF Dr. Smith is counseled into placing the removed equity into a life insurance policy with the contemplation of borrowing from the life policy, **none of the interest on the Home Equity Debt is deductible**. See the next section of the material for information on the interest deduction when repositioned equity is invested in a life insurance policy.

Disallowance of the Home Mortgage Interest Deduction

It's funny how nearly everyone (clients and advisors) thinks that if you take out Home Equity Debt (HED) that the interest on that debt is deductible. As you've already read, that is not the case. Interest on HED (See IRC Title 26, Section 163) is limited to $100,000 of new equity debt up to the FMV of the home.

While the issue rarely comes up by sales people pitching EH, the next issue that needs to be dealt with is: Can the deduction on HED be "disallowed" for any reason?

Again, nearly everyone who is asked this question will say that there are no restrictions on what you can do with the money obtained through removing equity from a home. For purposes of this material, the really big question is: Does the disallowance of the interest deduction apply when a client repositions equity into a **cash value life insurance policy** (classic Equity Harvesting).

Most readers will be surprised to learn that, if a client repositions equity from their home through HED (vs. Home Acquisition Debt) and moves that money into a cash value life insurance policy where the client is contemplating borrowing from the policy, the interest on the HED is **NOT deductible**.

Why is this important? Because it changes the financial viability of Equity Harvesting (which when sold the vast majority of time is sold on the concept of writing off the debt on HED).

Few advisors and virtually no clients are familiar with the following Code Section. This Code Section is not discussed in the Equity Harvesting world because it is very harmful to the sale of the concept.

Title 26 – Internal Revenue Code
Subtitle A - Income Taxes
Chapter 1 – Normal Taxes and Surtaxes
Subchapter B - Computation of Taxable Income
PART IX - ITEMS NOT DEDUCTIBLE

Section 264. Certain amounts paid in connection with insurance contracts

(a) General rule

No deduction shall be allowed for—

(1) Premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a **single premium life insurance**, endowment, or annuity contract.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

(3) Except as provided in subsection (d), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) **pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract** (either from the insurer or otherwise).

(4) Except as provided in subsection (e), any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963. Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

(b) Exceptions to subsection (a)(1)

Subsection (a)(1) shall not apply to—

(1) any annuity contract described in section 72 (s)(5), and

(2) any annuity contract to which section 72 (u) applies.

(c) Contracts treated as single premium contracts

For purposes of subsection (a)(2), a contract shall be treated as a single premium contract—

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

(d) Exceptions

Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100.

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date of first such increased premium is paid.

Interpreting the above Code Section

The previous Code Section needs a little interpretation. On its face, 264(a)2 simply states that, if a client borrows money (HED) and repositions the borrowed funds into a single premium life or annuity contract, the interest is NOT deductible.

Many advisors in the EH marketplace who have read that part of the Code Section say the way around this issue is to place the borrowed funds into a CD or money market account where the funds would then be used over a five-seven year period to pay life insurance premiums. While not discussed in this Module (see the Module on Life Insurance), when funding a cash value life insurance policy for retirement income, the premiums are typically paid into the policy over a five-seven year period to keep the costs of the policy down and to maximize cash values).

If Code Section 264(a)3 did not exist, using the tactic discussed in the previous paragraph would be sufficient to allow clients to fund cash value life insurance with borrowed funds and take the interest deduction on their personal tax returns.

Unfortunately, 264(a)3 makes the issue of writing off interest on a loan when the proceeds are used to fund life insurance very difficult.

264(a)3 states that if "…..any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) **pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract** (either from the insurer or otherwise).

While not described in great detail yet in this material, the concept of Equity Harvesting has as its foundation the ability of a client to borrow money and use that money to fund cash value life insurance so the money in the policy can grow tax-free and be removed tax-free in retirement.

How is the money removed from a life insurance policy in retirement? Through **systematic borrowing** from the life insurance policy. It's like the IRS had an EH sales person on staff when they drafted Section 264(a)3.

Is there any way clients can write off the interest on a loan when the money is used to fund life insurance as an investment/retirement vehicle? The answer is no with a big caveat–that caveat being that there are two ways to borrow money where life insurance can be funded and where the interest on the borrowed money will still be deductible. Neither way will be fully discussed at this point of the course material. Having said that, the two ways to deal with this Code Section are:

1) The client can use "other" funds to purchase the life insurance and use the borrowed funds for other reasons (or as part of the premium in accordance with 264(d))

2) The client can reposition the borrowed funds into an LLC which can then purchase as one of its investment a life insurance policy (which with fairly simple accounting procedures the client can affectively have access to the cash values income-tax free).

The two above ways to deal with Code Section 264 are more fully discussed on page 23.

Moving forward with the course material

The next section of this course material will work under the assumption that you can show your clients how to remove equity (money) from their homes through Home Equity Debt (HED) and reposition that money in life insurance where the **interest on the loan will be deductible**.

Not for everyone

While the arguments in this material for why clients should use Equity Harvesting are very powerful, the concept is not for everyone. If a client will sleep better at night knowing he/she does not have a home mortgage payment, then it is worth foregoing wealth building through EH to have that peace of mind.

For this education module, the material will focus on the financial benefits or problems with Equity Harvesting. This is not sale's material. If you want more complete material on Equity Harvesting, you can read about it in Roccy DeFrancesco's book, The Home Equity Management Guide: Retire Early Using Equity Harvesting or Pay-Off Your Home Mortgage in as little as Seven (7) Years.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Equity Harvesting

The WPI defines EH as follows:

> ***EH is removing equity from a personal residence or commercial property through refinancing (or a home equity loan) where the money borrowed is placed in cash value life insurance.***

The following material will illustrate to readers the power of EH and how the concept can be used the correct way to help clients build wealth quicker and in a more tax-favorable manner for retirement purposes.

Borrowing money to invest for retirement

The question is a simple one—Should a client borrow money to invest for retirement purposes?

While the question is simple, the answer is not readily apparent.

The answer to this question depends on three main factors.

1) <u>Can the client write off the interest on the loan</u>?

What if the client <u>**can't**</u> write off the interest on the loan? The answer to that question is it depends, and this will be discussed later in the course material.

2) Can the client reposition the borrowed money into something that will grow in a tax-favorable manner?

3) Can the client reposition the borrowed money in something where the client can have access to the funds (plus investment returns) income-tax free when needed (usually in retirement).

If all three factors are met, then the client's answer to the question should be all day long and as much money as I can afford to borrow. This is the concept of Equity Harvesting borrowing money where the interest is tax deductible and where the borrowed funds are invested into cash value life insurance where the money can grow tax-free and where the client has access to the cash income tax-free via policy loans.

Factor 1) has been discussed in the previous material. Therefore, let's focus on factors 2) and 3).

Typical after-tax investing

To be able to review the math and determine if Equity Harvesting is financially viable, it is important to understand the costs of investing money in the stock market as an after-tax investing.

Where do clients typically invest money after they take it home from work and pay income taxes? Stocks, mutual funds, real estate?

What's the problem with investing in stocks and mutual funds?─taxes and loads. When investing in stocks and mutual funds, the client has to deal with capital gains and dividend taxes. While this material is not meant to give chapter and verse on investing in stocks and mutual funds, it is important to explain the variables at play and a little history of how well clients have done while investing in the market.

Generally speaking, when a client has a stock/mutual fund portfolio, there is turnover in the portfolio as individual stocks and mutual funds are sold and purchased.

<u>Short term capital gains taxes</u>

If an investment is purchased and sold within 12 months, there is a short-term capital gains tax due. That tax is at the client's ordinary income tax bracket. So if a client is in the top marginal tax bracket, there is a 35% tax on the gain.

<u>Long-term capital gains taxes</u>

If an investment is held for more than 12 months before selling it, the client will pay a long-term capital gains tax. Today that rate is 15% although it is scheduled to increase in the coming years should Congress not act to extend the lower rate.

<u>State capital gains taxes</u>

Many states have their own state capital gains tax due on investment gains. California, for example, has a tax of more than 9%. If you live in California and have a short-term capital gain and are in the highest income-tax bracket, the tax paid on the gain is in excess of 44%. For long-term gains, the tax would currently be in excess of 24%.

<u>Dividend taxes</u>

If a client holds stock that pays an annual dividend (income to the stock holder), that dividend is taxed at the client's ordinary tax-bracket. The following are the current income tax brackets

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Married Filing Jointly or Qualifying Widow(er)

If taxable income is over--	But not over--	The tax is:
$0	$15,650	10% of the amount over $0
$15,650	$63,700	$1,565.00 plus 15% of the amount over 15,650
$63,700	$128,500	$8,772.50 plus 25% of the amount over 63,700
$128,500	$195,850	$24,972.50 plus 28% of the amount over 128,500
$195,850	$349,700	$43,830.50 plus 33% of the amount over 195,850
$349,700	no limit	$94,601.00 plus 35% of the amount over 349,700

Therefore, if a client (married) received dividend income from a stock portfolio and earns $128,500-$195,850, there will be a 28% tax due on the dividend.

Other expenses

What other expenses do clients have when they invest money in the stock market?

-Money management fees (annual fees paid to an advisor to give advice as to which stocks and mutual funds should be bought and sold (and when they should be sold)).

-Mutual fund expenses (fees clients pay annually to own the mutual fund).

In an attempt to keep this course material short and to the point, industry averages will be stated and used.

Money-management fees will range from 1.5% for small brokerage accounts to as low as .2-.5% for larger brokerage accounts (as accounts reach millions of dollars, most money managers reduce their fees by a percentage basis). The fees are paid each year.

For mutual fund expenses, the typical mutual fund has a load of between 1.2%-1.5% annually.

Why is it important to know the various fees on a post-tax brokerage account? Because we are going to compare paying premiums into an over funded cash value life insurance policy vs. post-tax investing in a brokerage account, and we need to define the annual expenses of each so we can have as close to a comparison as possible.

The comparison is pay premiums of X amount into a cash value life insurance policy or invest X into a brokerage account.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

The final question that needs to be answered is: What will the stock market return over the next 10-20-30 years? Obviously, no one knows that answer. For this course material, we will assume a 7.5% gross rate of return on an investment portfolio. 7.5% is less than what the S&P 500 has returned over the last many years. Some people think the market will do better going forward and some less. 7.5% however is a nice middle ground number that will be used for illustration purposes.

Answering the age old question: Is it better to fund cash value life insurance after-tax as a wealth accumulator or fund a traditional brokerage account?

Before we run the numbers on Equity Harvesting where we will assume the client can borrow money, invest it, and **write off the interest**, we need to run the numbers on whether it is a good idea pay premiums into a cash value life insurance policy after-tax instead of investing in stocks and mutual funds.

Let's go ahead and try to create a few real world examples using the following assumptions:

Example 1

Assume the following:

1) The client has a blended capital gains/dividend tax rate annually on the investments in a brokerage account of 20% (most in the industry use 30-35%; but to create a conservative illustration, this material uses 20%); and

2) That there is **no money**-management fee (the client is self-directing his/her investment accounts); and

3) Loads on investment money. Let's assume **half** of the money invested is going into mutual funds where the load is 1.2% annually.

Amount invested = **$20,000 per year for five years** ($100,000 which is also the maximum amount of money that can be removed from the house through HED where the client can still write off the interest).

Assume the client is age 45, is in good health, will retire when he (Dr. Smith) is 65, and draw down his brokerage account from ages 66-85.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

The following chart shows how money actually will grow in the post-tax brokerage account and how it comes out in retirement. You'll notice that the chart has been abbreviated by hiding some of the years. You'll also notice the annual rate of return is a net 5.4% (7.5% x 80% (20% capital gains/dividend taxes) – .6% mutual fund expenses (1.2% on half of the account)). The following chart shows the client being able to draw the account down by removing $21,446 each year for 20 years.

Age	Start of Year Balance	Contribution	5.40% Growth	Year End Balance
45	$20,000		$1,080	$21,080
46	$21,080	$20,000	$2,218	$43,298
47	$43,298	$20,000	$3,418	$66,716
48	$66,716	$20,000	$4,683	$91,399
49	$91,399	$20,000	$6,016	$117,415
50	$117,415	$0	$6,340	$123,755
55	$152,730	$0	$8,247	$160,978
60	$198,668	$0	$10,728	$209,396
65	$258,423	$0	$13,955	$272,378
70	$238,146	($21,446)	$11,702	$228,402
75	$183,873	($21,446)	$8,771	$171,198
80	$113,276	($21,446)	$4,959	$96,789
85	$21,446	($21,446)	($0)	($0)

Funding cash value **life insurance**—What if the client instead paid **$20,000 a year premiums into a life insurance policy**? How much could the client "borrow" from the life insurance policy income-tax free for the same period of time?

The following spreadsheet illustrates the money going into an indexed equity universal life policy with the returns pegged to the S&P 500. The material assumes the S&P 500 will average 7.5% in the life insurance policy (which is lower than what most analysts think the S&P 500 will return in the end).

Again, this module is not an education module on life insurance. To read about indexed equity life insurance where the growth in the policy is pegged to the S&P 500 (with a cap which varies per company) and with a 2% minimum guaranteed on cash value growth, please read the life insurance module from this course.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Age	Planned Premium	2% Rate of Return (Guaranteed) Cash Surrender Value	Cash Account Value	Rate of Return	Death Benefit Coverage
45	$20,000	$9,665	$10,576	7.13%	$433,425
46	$20,000	$23,502	$26,319	7.30%	$433,425
47	$20,000	$42,255	$48,038	7.37%	$433,425
48	$20,000	$61,260	$71,259	7.40%	$433,425
49	$20,000	$80,609	$96,093	7.42%	$433,425
50		$80,063	$102,207	7.42%	$433,425
55		$74,402	$142,459	7.46%	$433,425
60		$55,138	$205,106	7.46%	$433,425
65		$21,552	$298,995	7.47%	$433,425
66	($30,470)	$0	$290,194	7.47%	$400,551
70	($30,470)	$0	$251,691	7.48%	$318,310
75	($30,470)	$0	$192,135	7.49%	$225,430
80	($30,470)	$0	$116,976	7.49%	$167,075
85	($30,470)	$0	$18,031	7.49%	$93,241
90			$72,953	7.49%	$185,229
95			$203,837	7.49%	$237,635
100			$471,134	7.49%	$522,274

Comparison

How much could the client remove from his brokerage account after-tax?

$21,446

How much could the client borrow tax-free from his life insurance policy?

$30,470 (**$9,024** better per year for 20 years or $213,360 over 20 years)

The life policy was significantly better as a wealth building vehicle than a typical post-tax brokerage account. Why? There are many reasons; but to keep this material brief, the main reasons are because 1) the policy was run at the "minimum" death benefit (MEC minimum) to keep costs low, 2) there are no dividend or capital gains taxes due on money as it grows, or 3) is removed via loans from the life policy.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Example 2

Assume all the same variables except **add in** a .8% money management fee paid to a money manager (which would reduce the 7.5% gross return to a 4.6% after expense annual return).

How much could the client remove from his brokerage account after-tax?

$17,548

How much could the client borrow tax-free from his life insurance policy?

$30,470 (**$12,992** better per year for 20 years or $284,940 over 20 years)

While not a complete summary on post-tax funding of life policy vs. funding a brokerage account, what the previous material illustrates is that using a life insurance policy to build wealth can work out well and be a nice alternative to purchasing stock and mutual funds regardless of writing off interest on Home Equity Debt.

Side Note:

If you are curious as to what kind of returns a client would need to average in the market in order for a brokerage account given these assumptions to outperform the client's ability to remove cash from the policy via tax free loan, the number is between 3-5% annually depending on the life insurance policy used. Having said that, if the client used a life insurance policy which credited 140% of what the S&P 500 returns, the crossover point would be as low as 3.5% annually.

Most clients believe the equity markets will return between 6-10% (most 8% or so) annually. If they believe that's what the markets will do, funding cash value life insurance will be a very good wealth building tool for them over the long term.

Additionally, please remember that life insurance does not work for all people. If a client is not in good health, he/she cannot use life insurance as a viable financial planning tool (although a spouse's life could be the insured or a second-to-die policy). Also, the younger a client is, the better the numbers will work. It is difficult to make EH numbers work if the client is over the age of 60 (unless the client can wait 15-20 years for the equity to build up).

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

Back to Equity Harvesting

As just illustrated, funding cash value life insurance is a wealth building tool regardless of where the client finds the money to pay the premiums (so long as the policy is funded at the minimum death benefit (MEC minimum)).

What about Equity Harvesting when the client is "finding" money to pay premiums by borrowing equity from their home? Remember that we are assuming the client **can** write off the interest on the loan at this point.

Why would a client want to equity harvest?

Would a client refinance a property if he/she could remove equity, reposition the borrowed money a tax-favorable environment, and write the interest off on the loan? Many would say YES. This topic becomes even more powerful when using the 1% Cash Flow Arm Mortgage. To read about the power of the 1% CFA Mortgage, see the other MMB™ course module on Types of Mortgage Loans.

Clients have been told for years to buy 30-year mortgages and pay them off as quickly as possible. Why? Does it make good financial sense? The answer is—it depends.

It is vitally important to qualify the client when looking at Equity Harvesting (which is different than simply using the 1% CFA to lower a client's mortgage payments so money can be freed up for investing).

With Equity Harvesting, you will be telling your client to withdraw $25,000, $100,000, $250,000, and sometimes $500,000 or more in equity from their homes so that money can repositioned in something tax favorable.

Why?

To build wealth in the most efficient manner possible using an asset that has "dead equity." What is dead equity? It is equity in the home that is not being used for investment purposes. It's sitting there, and so people use the term "dead equity".

Understand that the client's home is going to appreciate each year at 2%, 5%, 10%+ sometimes; and it will do so no matter if the house has debt on it or not. Think about that for a minute.

Then the question for the client is: Can the equity in the house which is not being used for investment purposes be used in a better manner?

Many times the answer is yes.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

The classic response

What is the classic response you'll get from clients when discussing this topic? The equity in their home is making them money because they are not paying interest on the loan to a bank. That's correct, but then you have to look at the numbers.

The client thinks that when they have a 6% loan on their home, their equity is making them 6% a year as an investment. So the client would say: I've paid down my home $100,000 over the last 10 years; and this year, because I don't have to pay interest at 6% on that $100,000 of equity, I really made $6,000 this year. Wrong.

The interest on Home Acquisition Debt is deductible. Assuming the client is in the 40% combined federal and state income tax bracket, IF the client had to pay interest on the loan, the cost would not have been $6,000 but instead would have been $3,600 out of pocket. Therefore, the client only made 3.6% on their money (and it is not compounding every year because the client isn't really investing it every year).

Real World

As anyone who reads The WPI's material, you will know that it is grounded in real-world advice and what really happens (not what a non-real world planner says might or could happen on paper).

In the above example, does the client think that he/she is saving $6,000 (or in the real world $3,600) a year by not having a mortgage on that extra $100,000 of equity? No. Does the client invest the saved money in anything (let alone something tax favorable)? No. The client does nothing and simply pays down the debt on a home which does not help him/her accelerate wealth building in a tax-favorable manner.

Equity Harvesting Example

Let's go back to our earlier example where the client would like to remove $100,000 of equity from the home because they know if postured correctly the interest will be deductible.

Dr. Smith is 45 years old, is in good health, and earns $350,000 a year in W-2 take-home pay as a surgeon. His current house is worth $700,000 with $200,000 of debt on the home where the current interest rate on that loan is 6% on a 30-year conventional mortgage. Assume Dr. Smith has had the mortgage in place for 10 years.

To implement Equity Harvesting, Dr. Smith could obtain a home equity loan for $100,000; but the interest rate would be around 8% in today's environment. Therefore, Dr. Smith will refinance the current $200,000 of debt and remove an additional $100,000 of debt. Assume Dr. Smith is going to use an interest-only loan where the interest rate is also 6%.

As you will or have learned from the education module on life insurance, the new $100,000 of removed equity must be paid into the cash value life insurance policy over a five-to-seven year period to minimize the costs of insurance.

If Dr. Smith repositioned $100,000 into an equity indexed life insurance policy over five years where the average rate of return pegged to the S&P 500 index is **7.5%**, he could borrow income-tax free **$30,470** from his policy from ages 66-85.

What is the annual cost to Dr. Smith to have this $100,000 repositioned in the life policy? $6,000 annually as an interest expense (which in the 40% income-tax bracket really costs Dr. Smith **$3,600** a year after taking the interest deduction on his tax return in the 40% combined tax bracket).

Therefore, the question for Dr. Smith is: Would he pay $3,600 a year to reposition $100,000 into a cash value life insurance policy?

The answer should be yes, and the following numbers prove the point.

To compare "apples to apples," Dr. Smith would have to invest $3,600 into a brokerage account every year he had the extra $100,000 debt on his home.

The brokerage account will earn the same 7.5% gross annually as assumed in the cash value life insurance policy. The 7.5% will be reduced by the blended capital gains and dividend tax rate of 20% annually on returns (which is below industry standard) and a 1.2% annual mutual fund expense on 50% of the account.

Then the comparison would be how much money could he removed from the brokerage account vs. how much could be borrow income-tax free from a life insurance policy over the same period of time.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

How much could a client remove each year after-tax from the brokerage account from ages **66-85**?

$14,402 ($288,040 in after-tax income from ages 66-85)

How much can the client borrow from the life insurance policy income-tax free each year from ages 66-85?

$30,470 ($609,400 total tax-free income from ages 66-85)

How much better did the client do using Equity Harvesting?

$16,068 (each year for 20 years) or **$331,360** **better** over the twenty-year retirement period.

Wait, you say, this is not a fair comparison because there is still $100,000 of debt on the home? That is true and can be factored into the equation a number of different ways. Two of them are as follows.

1) Dr. Smith has a $125,041 debt benefit that will pay income-tax free from the life insurance policy if he were to die at age 84. (FYI, 84 is approximately when the actuaries believe Dr. Smith will die). That will more than pay off the $100,000 debt on the home.

If the client pays off the debt on the home from the death benefit, the client's after tax retirement income would be more than DOUBLE using EH vs. the do-nothing scenario.

2) Dr. Smith could choose to pay down the debt on the house using less than the last four year's loans from the life insurance policy. If you subtracted $100,000 (plus interest servicing the last four years) from the additional benefit of $331,360, the client would still be approximately **$223,673 better** off using Equity Harvesting (remember the client will have to service diminishing debt as he pays off the $100,000 from the loan which totals $7,687).

If the client pays off the debt with borrowed money the last three plus years (age 82-85), the client still generates nearly double the retirement income of the do-nothing scenario.

Equity Harvesting if the Interest is NOT deductible

Still to come in this material is information on how to posture a client to write off the interest on Home Equity Debt. For this section of the material, we will work under the assumption that the debt is **not** deductible and then determine if Equity Harvesting makes sense.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

So the question becomes for the client–Would you borrow money if you could reposition it in something that would grow tax-free and come out tax-free in retirement?

The client won't know the answer until you give it to him/her by going over the following numbers.

Example

Let's use the same example as the previous section with our Dr. Smith who has income of $350,000, is age 45 (in good health), and a house worth $700,000 with $200,000 debt.

He refinanced the debt and removed an extra $100,000 for Equity Harvesting purposes. The borrowed funds were repositioned into a cash value life insurance policy over a five-year period and assume the money grows until age 66 at which time he could take tax-free loans from the policy. If the indexed equity life policy averaged returns of 7.5% a year (growth pegged to the S&P 500 index), he would be able to borrow **$30,047** from the life insurance policy from ages 66-85.

In our example, Dr. Smith had to pay a $6,000 interest expense each year on the interest-only loan that was in place on his $100,000 of new Home Equity Debt. If we assume it is **not** deductible, then to make an "apples to apples" comparison, the client would need to invest $6,000 a year (the amount of money allocated to the non-deductible interest expense) into a brokerage account.

If Dr. Smith invested $6,000 into a brokerage account each year until age 65, he would be able to remove $**24,003** each year from his brokerage account after-tax each year from ages 66-85. This illustration assumes that Dr. Smith continued to invest $6,000 into the brokerage account after-tax each year until age 85 (which would need to be done to have a true "apples to apples" comparison with EH since the loan stays with the client until death (remember he is supposed to die by actuarial determined standards at age 84))

Again, how much could Dr. Smith borrow from his life insurance policy income-tax free from ages 66-85? **$30,047** each year.

How much better did Dr. Smith do by borrowing money and **NOT** writing off the interest? **$6,044** annually or **$120,880** better over the 20-year period.

Again, when Dr. Smith turns age 84 (his assumed date of death), he still has $100,000 of debt on the home. That can be paid off from the death benefit of the life insurance policy or over a 3.3-year period using the borrowed funds annually from the life policy.

If you change the numbers to potentially make them more **real world** where the client also pays the .8% annual money-management fee (in addition to the annual blended capital gains/dividend tax and the 1.2% mutual fund expense on 50% of the portfolio (remember the variables from before)), then Dr. Smith would be able to remove **$21,355** each year from his brokerage account after tax (which would mean that EH when the interest is **not** deductible generated **$8,692** more per year in after-tax retirement income and **$173,840** more over the 20-year retirement period).

The WPI believes the above exercise is not overly important because there are two useful ways to posture a client to write off the interest on the first $100,000 of HED. However, if a client is looking to remove more than $100,000 of equity from the home or an amount that exceeds the FMV of the home, then a client will need to be fully informed on the numbers as they pertain to investing borrowed funds into a life insurance policy when the interest is **not** deductible.

Side note:

The client also needs to keep in mind that he/she has a large death benefit that will pay income-tax free when the client dies (in our $100,000 premium examples for Dr. Smith the initial death benefit is **$433,425**) and the cash in the life insurance policy has a minimum **guaranteed rate of return** of 2% (something a client does not have with an actively traded equity portfolio which is subject to double-digit losses in the market like years 2000-2002).

Another issues to be aware of: The Alternative Minimum Tax (AMT)

The AMT is a nasty little tax that few clients and advisors understand. More and more people are going to be negatively impacted by the AMT and will learn about it the hard way in coming years.

You've previously read about it to determine if the interest on a loan is deductible (HAD or HED).

How does the AMT affect the interest deduction?

It doesn't. The AMT does not affect the client's ability to deduct either HAI or HEI.

How does AMT affect the client when dealing with HED?

First, you need to understand that the AMT is a separate/additional tax you and your clients will have to deal with.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

In short, clients who qualify for the AMT who itemize their taxes and take a deduction for HED subject that deduction to calculation for the AMT.

What does that mean? It means that, if a client qualifies to be taxed by the AMT takes out HEI, writes off the interest, and the money is not used to improve the home, the client will then be subject to the AMT on the income allocated to the interest deduction.

What is the AMT calculation?

Generally speaking, clients who are subject to the AMT and who have HED simply take the income allocated to the HED interest deduction and multiply that by the AMT (26-28%).

Example

Assume a client who is subject to the AMT removes $100,000 of equity from their home (which did not exceed the FMV of the home) and repositioned that money in life insurance (Equity Harvesting). Assume the interest rate on that $100,000 debt is 7%. To calculate the AMT on the income deducted due to the HED interest, simply take the AMT rate (assume it is 28%) and multiply that by the income amount ($7,000 in this example was deducted by the client for HEI).

The AMT a client would have to pay for the year where $7,000 in income was deducted from the tax return due to HED interest is $1,960.

The AMT will affect clients who earn $62,550 (married filing a joint return) in 2006 and $45,000 in 2007.

Does the AMT kill the concept of Equity Harvesting?

Absolutely not.

If you assume the client in the above example takes the interest deduction got the HED and we assume that triggers the AMT, the long term benefits of EH are still significant.

Let's look at the math. If this client is 45 years old and is in the 40% combined federal and state tax bracket, the after-tax dollars the client would have had to invest in the stock market had he/she not borrowed $100,000 thereby creating a $7,000 interest expense would be $4,200 ($7,000 x 60%). If you add to that $4,200 the AMT of $1,960, the client would have $6,160 to invest (which would be used to compare how much the client could borrow from a life insurance policy).

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

How much could this client remove after-tax from a brokerage account funded with $6,160 (with a gross annual return of 7.5%) from ages 66-85? **$14,700** each year.

How much could this client borrow from his life insurance policy (earning a gross return of 7.5% annually) tax-free from ages 66-85? **$30,470**.

These numbers are more favorable than if the client did not write off the interest on the borrowed money which as you know from previous reading still worked out as a very nice wealth building tool for the client.

The WPI's opinion on the AMT is that it will be significantly amended to only affect the wealthy (those making $350,000 or more a year) or it will be completely repealed. As of the time of this writing, Congress is considering legislation to either repeal or amend the AMT. The bottom line is that you want to make your clients who will be subject to the AMT tax know it exists and explain to them that, while it will affect the viability of EH, the concept is still very viable and should be strongly considered as a plan to grow the client's wealth for retirement purposes.

Other Variables

As with anything, there are pros and cons to any topic; and EH is no different. With any wealth building tool, clients must play the "what if" game.

-What if the S&P 500 does not return 3-5% or more annually?

-What if my post-tax brokerage account could have returned 12% annually had that been funded instead of cash value life insurance?

-What if a variable loan rate was used and interest rates climb.

-What if the interest turns out not to be deductible?

The key as an MMB™ is that you know the laws that affect this concept, that you give full disclosure to your clients on the way the concept is illustrated, and that you point out not just the pros with this topic but also the cons.

The WPI believes the numbers are sufficiently strong and proved in this education module to such a point that an MMB™ can say with confidence that Equity Harvesting is a good idea for many clients from a pure financial point of view. With full disclosure of the variables, clients who can understand basic math will move forward with the concept of Equity Harvesting.

Ways to write off the interest for HED

Now that you know the concept of EH is a good financial tool whether the client writes off the interest or not, let's examine the two ways a client can posture themselves so the interest should be deductible in spite of Section 264(a).

Remember, Section 264(a) states that, if a client falls under (2) or (3), the interest on HED is NOT deductible.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a **single premium life insurance**, endowment, or annuity contract.

(3) Except as provided in subsection (d), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) **pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract** (either from the insurer or otherwise).

How can a client borrow money against their home for HED and write off the interest?

1) Use other money to purchase the life insurance

It sounds simple enough and will be easy to understand through an example.

Example

Dr. Smith, age 45, has $250,000 in a brokerage account he has been building for years. He is like most Americans in that his average rate of return on his portfolio is less than 3% (for information as to why Americans averaged less than 3% from 1984-2002 (one of the biggest "bull" runs our stock market has ever seen) when the S&P 500 averaged over 12%, see the WPI educational module on the Maximizer).

Dr. Smith likes the concept of EH and wants to borrow $100,000 of HED out of his home to invest. He understands Section 264(a) and so, before implementing an EH strategy, he takes $100,000 from his brokerage account (after any capital gains taxes are due) and funds a Single Premium Immediate Annuity (SPIA). This SPIA's sole purpose is to pay five annual premiums into an indexed equity life policy in the amount of $100,000 (plus any investment returns minus income taxes on the income from the SPIA).

After the SPIA has been funded, the client can then borrow money from his home through HED and invest that money in any way he sees fit. Dr. Smith might use the money to buy real estate or start a new business or whatever. What Dr. Smith will not do with the money is fund a life insurance policy.

As stated, this is a simple way to make the interest on HED deductible under Section 264(a).

What's the problem with this solution? Many clients who you will want to sell EH to and who will want to buy into the concept of EH will not have outside funds available to fund a SPIA. Like many things in life, the EH concept is another one of those the rich-get-richer topics. That's just life. Those with money typically have more options and the EH concept is no exception.

2) The use of an LLC for investment purposes

The use of an LLC is not the easiest to explain and will not be fully explained in this educational module. However, you will learn the basic structure so you can determine if it is one you would like to look into further.

When implementing the EH structure, a client will first create a multi-member Limited Liability Company (LLC). Other members might include a spouse, majority age children, or a trust for the benefit of the children and/or spouse.

The other members will contribute 10% of the money that will ultimately be contributed to the LLC, and the client will contribute 90%.

In our $100,000 EH example, the client, Dr. Smith, will fund the LLC with the borrowed funds as a contribution. The other member (let's use a trust for the children's benefit as the other member) will contribute $11,000 to the LLC as a contribution.

Dr. Smith will be the managing member of the LLC and have a 90% interest in the LLC, and the trust will be the non-managing member and will have a 10% interest in the LLC.

As the managing member of the LLC, Dr. Smith makes the decisions about where the money in the LLC is invested. Dr. Smith could make the decision that some or all of the money in the LLC could be used to fund a cash building life insurance policy.

Let's assume Dr. Smith did, in fact, buy a cash value life insurance in the LLC (which could be on his life or on one of the beneficiaries of the trust). What happens?

The life insurance policy is funded over 5 years to maximize cash values and minimize insurance costs.

Dr. Smith as the managing member can have the LLC take tax-free loans from the life insurance policy owned by the LLC at any time.

Dr. Smith could wait until age 66-85 to have the LLC borrow money from the LLC.

Then through a special allocation, the LLC can transfer that money to Dr. Smith income-tax free (which Dr. Smith can use as tax-free retirement income).

Again, this material does not go into detail on the LLC structure which allows for the special allocation to come out to Dr. Smith tax-free. The simple way to explain why Dr. Smith has not taxable income from the allocation is due to the fact that when the LLC borrows the money from the life insurance policy, Dr. Smith will individually guarantee the loan. When Dr. Smith guarantees the loan, his basis in the LLC goes up by the amount of the loan. When the special allocation is given to Dr. Smith, his basis in the LLC goes back down by the same amount; and it is a wash.

The LLC structure is an “advanced” structure that few in the country are familiar with and, as stated, this material is not meant to make you an expert in the topic.

What you need to know about the LLC structure is that it is a viable option when trying to deal with the 264(a) problem of not being able to write off the interest on HED. Because the borrowed funds go into a multi-member LLC where the funds and life insurance can be used for many different purposes (estate planning, other business ventures), the interest on the HED should be deductible.

The main problem with the LLC structure is that there is a cost to the LLC. The cost to set up the LLC should be $5,000 (although MMB™ advisors can have their clients buy it through the C.A.L.M. Plan for $3,000), and there are small additional costs of annual tax returns.

Summary on options 1) and 2) for how to write off the debt on HED when using the EH concept

Option 1) is simple, but many clients do not have significant other monies which can be used to fund the life insurance policy.

Option 2) while it sounds complicated is really not, but there is an up-front cost to create the LLC and a small fee to maintain it every year.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)

If you are going to deal with the EH concept for your clients as an MMB™, you MUST tell the clients about Section 264(a) and not do what most advisors seem to do which is to tell the client to seek advice from their accountant/CPA/EA. As a MMB™, you are not a tax advisor and are not giving tax advice. Having said that, you must give full disclosure to your clients on this issue and tell them the options for writing off the interest and also show them the numbers should they choose not to write off the interest (which are still very powerful).

Summary on Equity Harvesting

From a financial standpoint (without emotion), EH when done right can be virtually a no-lose proposition for clients. Money is borrowed and repositioned where, even in the worst case scenario over the long haul, it should grow at 6% and more likely will grow at 8%. That money can grow tax-deferred/tax-free in a life insurance policy. The client will be able to write off some or all of the interest on the loan which further enhances the financial viability of the concept.

EH is a concept that can be very abused by those who do not deal with it forthright in a full-disclosure manner with clients.

This material was created to give MMB™ advisors the details which are lacking from books such as Missed Fortune 101 and other sale's programs.

EH is a very viable financial tool for many clients who wish to build wealth in a tax-favorable manner for retirement purposes. That is true whether clients are able to write off the interest on the HED or not.

With full disclosure, you can use the EH topic as a great client-gathering tool and a tool to help clients build wealth in a tax-favorable manner by helping them properly manage the equity in their homes.

If you are a financial planner and are going to deal with the concept of EH, the WPI strongly believes that you should use the knowledge gained from the MMB™ course and process your clients' mortgages in your office or to team up with an MMB™ advisor who works mainly in the mortgage industry.

If you are a mortgage broker by trade and are going to deal with the concept of EH, the WPI strongly recommends that you obtain your life insurance licenses so you cannot only sell the mortgages but also sell the life insurance policies. If you do not desire to get into the life insurance "business," then it is recommended that you team up with another MMB™ or CWPP™ advisor in your area who specializes in EH.

Copyright 2007, The Wealth Preservation Institute (www.thewpi.org)