Permanent Life Insurance Policies – Options When Coverage is No Longer Needed

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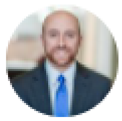

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Many people purchase permanent life insurance in their 30s and 40s, when their kids are young and the risk to the family is significant. At that point, for many, life insurance is a proverbial box that has been checked, and for many years (and even decades), the premium notice comes in the mail, a check gets written and there isn't another thought about it until the next year when the bill arrives once again. Rarely do people think to readdress the need for coverage while the years continue to pass.

Yet, goals and objectives for life insurance policies frequently evolve, whether due to family dynamics, legislative changes or changes in wealth. Beyond a policy's performance, which if left unchecked, can be a ticking time bomb (as I've written about many times previously), the need for the insurance – both the amount and type – commonly goes unaddressed. People who clearly should have term insurance own permanent insurance. People who should have millions of dollars in coverage have hundreds of thousands. For some, there may simply no longer be a need for the insurance at all. The kids are now grown, out of the house and financially independent. In those scenarios, there are a variety of options to consider as you provide guidance for your clients:

Repurpose – While the need may have changed, the life insurance death benefit can be a meaningful part of the client's wealth transfer planning. At life expectancy, many life insurance policy death benefits will have an internal rate of return in the 5-6% range. Considering that most policies pay an income-tax-free death benefit, the pre-tax equivalent IRR can be quite substantial. While the original purpose of the insurance may be different, maintaining the policy can provide security for the family. If maintained, be sure to order in-force ledgers at least every two years to make sure the policy will meet expectations and regularly review beneficiary designations.

Reduce Coverage – While there may not be a clear need today, clients may still wish to keep a portion of the coverage. Some policies offer a "Reduced, Paid Up" option that provides a guaranteed, but greatly reduced, death benefit with no future premiums. For policies without that nonforfeiture option, it is likely the client can still reduce the face amount and reduce or eliminate premiums while maintaining some amount of death benefit. For clients, who are still favorably insurable, it would be wise to compare this reduction to a 1035 exchange into a new, paid-up policy in today's market.

Long-Term Care Insurance – For many who own permanent life insurance, the biggest risk to the family when the policy was purchased was the early passing of an income earner. When the kids are grown, the biggest risk to the family quickly changes from a premature death to the risk of longevity and the cost of the associated care. For clients who own permanent life insurance, exploring a hybrid policy (a life insurance policy with an LTC rider) can be an enticing solution. By way of a 1035 exchange of the existing policy's cash value into a hybrid plan, your client could purchase a large pool of money for long-term care that grows at a guaranteed rate of inflation, provides an income-tax free death benefit and an "in case of fire, break glass" return-of-premium feature. These plans offer a fixed premium, guaranteed by contract, that cannot increase in the future and, in many cases, cash values from existing policies can fund all or most of the required premium.

Exchange into a Low Load or Fixed Annuity – If your client no longer has a need for life insurance, but has a substantial gain in the policy, a 1035 exchange into a low load or fixed annuity could be a solution. This exchange will remove the mortality expense from the equation (generally the most significant cost of owning a life insurance policy), continue to grow on a tax-deferred basis, and when the funds are distributed, the taxes are spread out so your client isn't looking at a significant income tax burden all in one year (that would happen upon a full surrender).

Supplemental Retirement Income – At the inception of a policy, many people will recall a discussion with the agent about the growth of cash and the potential for supplemental retirement income in the future. While distributions can be taken from many policies on a tax-advantaged basis, clients need to be very careful about how they manage the policy distributions year over year. Taking too many (or too large of) distributions can lead to catastrophic tax consequences in the future. Before suggesting anyone take a distribution from a permanent life insurance policy, it is critical to obtain in-force ledgers and to read the overloan protection rider agreement to put your client on a conservative path. Distributions without careful planning and a strong understanding of the product's mechanics can truly be a recipe for disaster. Remember, any policy with a loan must be carefully managed until the day the insured life passes away, even if incapacitated.

Surrender and Reinvest – If your client is behind in retirement planning, the policy's cash value could be a meaningful asset and a full surrender can sometimes be the best option (depending, of course, on how big of a tax burden the surrender could be). If there is a substantial gain in the policy, the client will most likely be looking at an ordinary income liability, but… the cash surrender value provides cash on-hand to pay the tax (i.e. a cash surrender value of $500,000 and a basis of $400,000 could lead to a taxable event of $35,000-$45,000 depending on the tax bracket – but the client is still netting $455,000-$465,000 for reinvestment after the tax is paid).

Sell the Policy – The life settlement market is as competitive as it's ever been. Generally speaking, if your client is over age 75 with underlying health issues and no longer has a need for the insurance (or can no longer pay the premium), a settlement can potentially put your client in a position to walk away from the policy with significantly more cash than the cash surrender value alone. Clients also have the ability to retain a portion of the death benefit in lieu of a settlement payout if they still have a need for insurance. The greater the difference between the policy's cash value and the death benefit, the greater the interest will be from the settlement company. For that reason, universal life policies are greatly preferred to whole life policies.

The best option for your client is specific to his/her goals and objectives. Before making any changes, advisors are always encouraged to work in conjunction with the clients' professional tax advisors.

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