12

MANAGING MATURE POLICIES

Options for Contracts That Have Outlived Their Usefulness

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We are about to explore what is indeed a very good problem to have: outliving your need for life insurance.

It is commonplace for retirees to reach social security age and find their life insurance no longer serves its intended purpose. Most people secure life insurance when their children are young. If they pass away pre-maturely, they would want their family to live the same lifestyle as they were accustomed to living.

Other situations lending themselves to policies that have outlived their purpose include business owners who had policies for important business needs, such as insuring partners (who may have left the business). Or if the business is sold or closed, there may no longer be a need for coverage on shareholders or officers. Often divorce changes plans, either obviating the need for coverage or requiring it to back up promised alimony or child support obligations.

Fast forward to retirement age and many of our clients have enough money to retire comfortably, therefore the “need” for life insurance may be minimal. The question is, what do you do with your life insurance when you find yourself in this enviable position?

As we have seen throughout the previous chapters, there are numerous reasons to buy and hold insurance; multiple types of policies and carriers that may satisfy those needs; and sometimes competing strategies for moving forward. In short, there is no one-size-fits-all approach for entering into an insurance contract.

> *“What do you do with your life insurance when you find yourself rewarded with a long life and success?”*

Likewise, no single answer exists for the best approach to deal with mature contracts after the needs of the insured have changed. Rather than lay out a litany of hypotheticals, in this chapter we will look at a case study of my close friend David who represents a somewhat typical, but detailed example of the types of challenges one may face when rewarded with long life and success.

WHO THIS CHAPTER WILL HELP

The information presented here is intended for two audiences: any professional who may field questions from their clients about their choices for dealing with mature life insurance policies and policyholders curious about their own options.

If you are a financial, estate or tax professional, you may be aware of at least some of the options we will cover. Primarily, my goal is to expand your understanding of the various choices available, rather than provide instruction on how to enact them. When clients come to you asking if their coverage should be changed, you will have a better idea of how to orient them in the right direction. In the end, the best answer may be to enlist the input of another professional—one experienced in the nuances of these type of decisions.

On the other hand, if you are the holder of insurance policies and your life situation no longer matches the scenarios that drove your original purchase decisions, the examples here will spark your interest and spur you to consider your options. Of course, you will want to first consult with your trusted advisor before taking any actions, due to the tax and estate impacts that may result.

THE CASE OF THE RETIRED BUSINESS OWNER

To examine the various options for dealing with insurance that has outlived its intended purpose, we’ll follow my friend, David, as he considers what to do with two mature policies that he has held for years.

Case Study

DAVID’S SITUATION

After working many years, David sold his business, went on social security, had a pension plan kick in and began to take minimum required distributions from his IRAs.

- *David is age 70 and is reasonably healthy, but has a few minor health concerns.*
- *He has done a great job planning for retirement and no longer “needs” life insurance.*
- *He owns a Whole Life (WL) policy issued in 1995. It has:*
  - *A current death benefit of $400,000*
  - *A cash value of $200,000, of which $100,000 are paid-up dividend additions*
  - *Cumulative premiums or “cost basis” of $100,000*
- *He also owns a Universal Life policy issued in 1990. It has:*
  - *A death benefit of $600,000*
  - *A cash value of $50,000*
  - *Cumulative premiums or “cost basis” of $100,000*

ISSUES OF CONCERN

- If David’s Whole Life policy is surrendered, he must recognize a gain of $100,000 subject to ordinary income tax.
- If the Universal Life is surrendered, there is no built-in taxable gain. He invested $100,000 and it is only worth $50,000. Unfortunately, he cannot take a loss on his tax return.
- If the policies are transferred out of his estate, it will use $250,000 of his lifetime gift tax exemption. This would be an issue to consider if, for example, he transferred the policies to

his children. A transfer to a new owner may create a transfer-for-value problem that one should be aware of.

Now that we understand the basic parameters of his situation, let's walk through the options David may want to consider.

DAVID'S OPTIONS

1. KEEP THE POLICIES

A. Take a lump sum distribution out of the Whole Life policy tax-free

David can surrender paid-up additions from his $100,000 basis out of his policy without any income tax implications. He can then borrow more than his basis and still not be subject to income tax. In this example, after receiving his $100,000 basis, he can take a $60,000 loan, leaving $40,000 of cash value in the Whole Life policy. The $40,000 would be "projected" to keep the life insurance in force forever without additional out-of-pocket costs. At David's death, his heirs would still get some nominal amount of life insurance death benefit tax-free. So, in this hypothetical projection, David would have taken out $160,000 of cash value which is $60,000 more than his basis, and his heirs could potentially receive $100,000+ of death benefit, all income tax-free.

B. Take an annual tax-free income stream out of the Whole Life policy

It may be more advantageous to take an annual income stream from your policy instead of taking a lump sum distribution. The income stream can be an additional source of retirement income, or give a dependable cash flow for gifting, etc. The taxation method used is "first in – first out" (FIFO). Under this treatment, David first surrenders dividend additions equal to the basis (the actual premiums paid) tax-free and then uses policy loans against the remaining cash to avoid taxation. In this example, David can take an annual income stream of $11,000 per year and upon his death, his beneficiaries will receive the remaining death benefit tax-free. One must be very careful not to take out too much cash

value to the point where the policy can no longer sustain itself. The risk of a policy lapsing in the future is that it could trigger immediate taxation of the gain at ordinary income tax rates.

2. SURRENDER THE POLICIES

When there is cash available in two different policies David owns, he may choose to cash them in and use the money to augment his retirement income.

A. Immediate Surrender

David receives a combined $250,000 for his Whole Life policy and Universal Life policy. However, it comes with a 1099 reporting $100,000 of income. If David was in a 35% tax bracket, he would have to pay $35,000 in ordinary income taxes and receive a net $215,000 upon surrender.

3. RESTRUCTURE THE POLICIES

Despite our assertion that David no longer "needs" the life insurance, there may be instances in which he may wish to keep them in force a bit longer, without paying additional premiums. For example, David may choose to spend other assets and have the life policies be the primary bequest to his kids.

In that instance, there are two ways in which David can achieve this objective.

A. Reduce the Whole Life policy death benefit with a "Reduced Paid-Up Policy"

When a Whole Life policy's death benefit is reduced to a paid-up policy, the insurance company calculates how much life insurance a policyholder will receive with no further premium payments. In a Whole Life policy, it is a contractual guarantee of the original policy that no further premiums are required and David's heirs would get a fixed amount of insurance whenever David passes away.

In this example, the $200,000 of cash value would secure a reduced paid-up policy of about $285,000 of death benefit.

B. Reduce the face amount of the Universal Life policy and stop paying premiums

This technique is comparable to a Reduced Paid-up Whole Life policy option. However, there is a significant difference with a Universal Life policy. Whereas with a Whole Life policy there is a "contractual" guarantee, it is not the case with a Universal Life policy. In this example, the $50,000 of cash value could support a face amount of $90,000 for the life of the insured. Again, it may only be a hypothetical projection based on the insurance company's assumptions on interest rates, expenses and cost of insurance rates.

There are also some other esoteric issues to navigate, such as minimum required face amounts for historical premiums paid, or the possibility of being charged a "surrender" charge when the face amount is reduced. The biggest landmine is if the insurance carrier reduces interest rates or changes the policy expenses. Either of these two changes by the carrier could trigger the need for additional premium payments. The bottom line here is to always consult an expert before making any changes to a policy.

C. Change the Whole Life policy into "Extended Term Coverage"

Here the insurance company will give the policyholder the full $400,000 of insurance for a limited term of years, but David would run the risk of outliving the life insurance and lose the policy's cash value. In this example, he would have $400,000 of insurance for 18 years, then no coverage thereafter.

D. Keep current policies and use tax-free income to purchase a "Second-to-Die" policy in an Irrevocable Insurance Trust

Suppose David has planned well for his retirement and doesn't need the life insurance for retirement income. Instead, he would like to leave a legacy to his children. Since he doesn't need the $11,000 per year to meet his immediate needs, he could gift this money to a trust each year that owns a "Second-to-Die" life insurance policy on him and his wife (assuming she is a healthy 65-year-old). The $11,000 per year would purchase a Survivor Universal Life (SUL) policy with a $650,000 face value. The $650,000 policy can be structured in such a way that it could be outside of David and his

wife's taxable estate and protected from creditors. In, this example there would be no gift tax consequences for the annual gift.

4. EXCHANGE INTO A NEW POLICY

A. Tax-Free 1035 Exchange into a new "Guaranteed Paid-Up" life insurance policy

Assuming David is still insurable, he could exchange the existing policies for a $500,000 Guaranteed Paid-Up policy insuring him. These types of policies come in many different forms, but the essence of the concept is that the tax-free exchange avoids all taxable gains of the policy and provides his heirs with 100% guaranteed insurance—all without ever having to pay another premium.

In this circumstance, David would have to buy either a special single premium Whole Life policy or a Universal or Variable Universal Life policy with secondary death benefit guarantees. If he bought a policy without secondary guarantees, then he would run the risk of the carrier changing the cost of insurance, crediting interest rates, or expense charges, which would negatively impact the length of coverage on the policy. If this strategy is implemented correctly with the right product, it would be a better option for David than the "Reduced Paid-Up" options on the existing policies as it provides $500,000 of coverage compared to $285,000. This strategy would likely deplete all of his cash so it is important to accurately understand David's goals and ensure his primary need is a death benefit, not cash for retirement.

B. Tax-Free 1035 Exchange into a Guaranteed Paid-Up policy with a "Long-Term Care Rider"

Prior to making a decision to do a 1035 exchange into a new policy, David should consider whether he needs Long-Term Care (LTC) insurance. There are now life insurance policies where, in addition to providing a death benefit, they also provide a living benefit in the form of long-term care insurance if the need arises. Under this strategy, if a long-term care rider is added to the new policy, instead of providing $500,000 of potentially paid-up life insurance, it would provide $450,000 of life insurance PLUS a long-term care benefit of $9,000 per month payable for four years.

This rider pays the LTC benefit from the death benefit in order to reimburse David for home or nursing home health care. The part of the death benefit that is not consumed for LTC expenses during David's lifetime will be paid as a death benefit to his beneficiaries. For example, if David receives $9,000 per month for a full year and then passes away, of the $450,000 death benefit, he would receive $108,000 tax-free during his lifetime and his beneficiaries would then receive $342,000 tax-free at his death.

Please note that any 1035 exchange into a new policy, however it is structured, requires underwriting. Thus, this strategy will only work if David is healthy enough to have a new policy issued at an acceptable underwriting class that will economically make sense. Also, it should be noted that if there is an LTC rider, there will be additional underwriting requirements for the LTC coverage.

C. Tax-Free 1035 Exchange into a HYBRID Life/LTC policy with "Guaranteed Return of Premium"

Another option for David is a tax-free exchange of the $250,000 existing cash value into a policy that provides a $900,000 pool of long-term care benefits, but with only a $300,000 death benefit. This policy is provides more LTC coverage and less death benefit.

The unique feature with this policy is there is a Guaranteed Return of Premium feature that can be triggered at any time. Similar to the other 1035 exchanges, David can also carry over the basis from the other two policies and avoid income tax on any gains. However, if David decides to trigger the return of premium option, there will be tax consequences.

D. Tax-Free 1035 Exchange into an Annuity

I. Exchange to a Deferred Annuity

If David doesn't see the need to keep his current life insurance or replace his insurance with another policy, then it might make sense for him to do a 1035 exchange into a deferred annuity. This type of transaction allows David to carry over his basis from the life insurance policies into the annuity and avoid current income taxation of any gain.

A tax-free exchange to an annuity would start out with

$250,000 of value and $200,000 of basis. If surrendered, it would be subject to only a $50,000 gain because of the ability to carry over the full $200,000 of basis from the two policies owned.

There are some rules regarding the amount of time David may need to hold the annuity to avoid the taxation. Also, David may incur surrender charges if he surrenders the annuity contract within a certain period. Depending upon David's risk tolerance and current retirement portfolio, he may consider buying either a Fixed, Variable or Indexed annuity. Annuities do not require underwriting, but they still have mortality and other fees and expenses associated with them, depending upon the contract selected.

II. Exchange to a Single Premium Immediate Annuity

If David has a need for additional income during his retirement years, he may want to consider exchanging the cash value of his two insurance policies into a single premium immediate annuity. An immediate annuity might provide David with an income stream of $18,000 per year for life.

From a taxation standpoint, a portion of annual payment may be considered a return of basis and the other portion subject to ordinary income (the exclusion ratio). Once David receives 100% of his basis back, all of the income stream would be 100% taxable as ordinary income.

5. GIFT OR TRANSFER THE POLICY TO A NEW OWNER (CHARITABLE CONTRIBUTION)

David may wish to donate one or both of his policies to a charity of his choice if he is charitably inclined. The most effective way to accomplish this goal is to transfer the policy to a charity so they become the owner and beneficiary of the policy. By doing so, David would be entitled to an immediate charitable deduction for income tax purposes. He may also choose to continue to pay the premiums on the policies. If he does, each payment is also a deductible charitable donation. In addition, the policy is removed from his estate which could result in some estate tax savings.

When a contribution is made to a charity, the charitable deduction is not necessarily based upon the policy's face value or cash surrender value. The deduction is limited to the policies fair market value, or cost basis, whichever is less. Determining a policy's fair market value is complex and not within the scope of this book.

You should also be aware that the income tax charitable deduction for a donated life insurance policy (as well as future premium payments) generally are limited to 50% of adjusted gross income (30% for gifts to a non-operating private foundation). Excess deductions can be carried forward for five years.

We would need a lot more facts about David's income and overall financial planning situation to determine if this is a good alternative.

6. LIFE SETTLEMENT

Another option for an unwanted or unneeded life insurance policy is a Life Settlement. In a life settlement, there are third-party institutional investors that purchase policies on the lives of seniors who no longer want or need their life insurance policies. The institutional buyers will pay the policy owner a cash payment, which is more than the current surrender value, but less than the death benefit. The new owner then pays all of the premiums going forward and has the right to receive the insurance proceeds at the insured's death.

It is important to note that not every policy is a good candidate for a life settlement. The ability to sell the policy depends on the insured's age and health, which means they usually need to be in their mid-70's or older or have a significant change in health since the policy was acquired. In addition, the policy dynamics (i.e. the cost of maintaining the insurance policy for the life of the insured) will play an important role. On average, a life settlement will be about 20–30% of the death benefit. In David's case, his Whole Life policy is not an attractive policy in the life settlement market, due to the high cash surrender value and ongoing premium payment. His Universal Life policy, however, may be attractive depending upon David's health and life expectancy determination. The investors who purchase these policies have strict criteria when doing so. As mentioned previously, they are usually looking for insureds over the age of 70 who have had a change in health since the inception of the policy.

"Life Settlement investors are usually looking for insureds over the age of 70 or those who have had a change in health since the inception of the policy."

Let's assume that David could sell his $600,000 Universal Life policy in the example provided for 20% of the face amount, or $120,000. In this case, David would receive $70,000 more than the cash surrender value on his policy. To determine whether this makes economic sense for David, the taxation of this settlement must be considered.

Taxation is currently determined by Revenue Ruling 2009–13. Currently, under this IRS Revenue Ruling, the taxation is different than if the policy was surrendered. The cost basis is not premiums paid, but premiums paid less the cost of insurance for the policy over the life of the policy. What is also different is the characterization of any gain on the sale versus surrender of the policy. Typically, most of the gain in a life settlement is characterized as long-term capital gain. It is recommended that the seller consult with an accountant to compute the potential tax consequences of this transaction.

Look for Changes

POTENTIAL TAXATION CHANGE

Stay tuned for a potential change to the taxation of life settlements. Currently pending in the US House of Representatives is a bill that would give the same tax treatment to those selling their policies as those that surrender the policy to insurance companies (see Amendment HR 1262). This bill would eliminate the 2009 rule's requirement that requires policy sellers to subtract the cost of insurance, or mortality charges, from the premiums they deduct when computing capital gains taxes.

WORKING WITH AN EXPERIENCED AND TRUSTED LIFE SETTLEMENT BROKER

You will want to choose and work with a life settlement broker that is licensed in your state to help you with a life settlement, which is a complex transaction. When evaluating who to work with, it is important to consider the following:

- **Confidentiality.** Work only with a broker who works exclusively with institutional funding sources. The third party who purchases the policy receives its return on investment only when the insured party passes away. It is extremely important to know who is buying the policy, since they have an interest in the insured passing away sooner instead of later. With institutional buyers, these policies are held in large blind trusts to assure client confidentiality.

- **Variety.** Make sure the broker works with several different licensed life settlement providers. Life settlement offers may vary widely among providers and are very sensitive to variables such as the insured's life expectancy, the policy's premium requirements, market interest rates and the status of the funder's current portfolio of policies. There are circumstances where "strong money" (readily available liquid reserves) would be available from one company at one point in time and then a completely different company at another point in time. For this reason, it is important to market the policy to as many providers as possible to capture the strong money in the marketplace at that point in time.

Caution

NO BIDDING PROCESS

A caution to consumers: there are some life settlement providers who are attempting to buy policies direct without a bidding process. Careful reading of their documents may reveal that their offers are significantly lower, as they only represent their side of the transaction.

- **Bidding.** Work with a broker who negotiates offers through a formal written bid process. It is impossible to predict who will have the strongest money at any given time. It is crucial to have a consistent and written process that finds the money for you and forces providers to make the highest offer possible. A formal, consistent bid process does just that. All providers are playing on a level playing field and the end result is consumers knowing they are receiving a true market value for their policy. The most reputable firms will provide bid history, including markets that did not make an offer for the policy in question.

- **Compensation.** Work with a broker where the compensation is uniform and capped. This will assure that the interests of the broker and client are aligned with obtaining and presenting the highest offer. Capped compensation assures that the company has a "ceiling" on the level of compensation it receives for marketing the policy. If the compensation is not uniform, the broker may have an incentive to shop the policy only to the provider that offers them the highest compensation, which may or may not be the provider who will pay the most money for the policy.

- **Disclosures.** One of the most important protections for the client is to work with a broker who discloses all the offers and total compensation to all parties involved and knows whether the state is regulated and requires these protections. Full disclosure assures that clients' interests are protected and that they are making an informed decision.

"Full disclosure assures that clients' interests are protected and that they are making an informed decision."

CONCLUSION

As you can see, David has a wide array of options at his disposal with regards to his life insurance policies that he no longer needs. There are no "cookie cutter" or "one-size-fits-all" solutions.

Proper planning, based upon David's goals and objectives is important. What works for David may not work for someone else with different needs and desires. A Life Insurance 10X advisor is one that will keep up with changing tax laws and new product innovations and continually find new strategies that best fulfill the client's needs when managing their mature life insurance policies.

PROFESSIONAL DESIGNATION DEFINITIONS

- Certified Financial Planner (CFP®) – The CFP® certification marks identify professionals who have met the high standards of competency and ethics established and enforced by CFP Board. CFP Board's Standards of Professional Conduct require CFP® professionals to act in their clients' best interests. For more information, see https://www.cfp.net/about-cfp-board/cfp-certification-the-standard-of-excellence

- Certified Public Accountant (CPA) – As with many other professions, accountants have a number of professional credentials and certifications designed to ensure a high level of professionalism. The most widely sought credential is the CPA, or certified public accountant. It is both a designation and a certification process. For more information, see http://www.aicpa.org/BecomeACPA/Pages/default.aspx

- Chartered Financial Consultant (ChFC®) – A professional designation representing completion of a comprehensive course consisting of financial education, examinations and practical experience. Chartered Financial Consultant designations are granted by The American College upon completion of seven required courses and two elective courses. For more information, see https://www.theamericancollege.edu/designations-degrees/ChFC

- Chartered Life Underwriter (CLU®) – A chartered life underwriter (CLU) is a professional designation for individuals who wish to specialize in life insurance and estate planning. Individuals must complete five core courses and three elective courses, and successfully pass all eight two-hour, 100-question examinations in order to receive the designation. For more information, see https://www.theamericancollege.edu/designations-degrees/CLU

- Million Dollar Round Table (MDRT), Top of the Table (TOT) – for a list of membership requirements, see: https://www.mdrt.org/membership/requirements/

- Association for Advanced Life Underwriting (AALU) – for a list of membership requirements, see: https://www.aalu.org/membership/join-aalu/
- Life Underwriter Training Council Fellow (LUTCF) – NAIFA's Life Underwriter Training Council Fellow (LUTCF®) Designation Program is often considered the first designation any insurance professional should earn and has delivered value to more than 70,000 professionals since 1984. For more information, see http://www.naifa.org/professional-development/pdp/lutcf
- Registered Financial Consultant (RFC®) – A professional designation awarded by the IARFC to financial consultants who meet high standards of education, experience and integrity. For more information, see: http://www.iarfc.org/default.asp
- Licensed Insurance Consultant (LIC) – A counselor's license will allow a person to counsel in one or more of the following areas with the proper qualifications: life (LI) insurance, accident and health (AH) insurance and/or property and casualty (P&C) insurance. Persons admitted to the practice of law in Michigan may counsel insurance without obtaining a license, but cannot represent themselves as licensed counselors by the State of Michigan. For more information, see http://www.michigan.gov/difs/0,5269,7-303-22535_60490_23035---,00.html
- Trust and Estate Practitioner (TEP) – A designation that is recognized worldwide and is a way to formally identify qualified trust and estate practitioners and distinguish them from non-specialists who occasionally deal with trusts and estates. For more information, see https://www.step.org/sites/default/files/Basic_principles_of_marketing/Why_Become_a_TEP_2011.pdf

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