It is Time to Review Your Life Insurance Coverage!

By Tammy Wener, CFP®, MBA

According to the American Council of Life Insurers, by the end of 2014, total life insurance coverage in the United States was $20.1 trillion, and $11.8 trillion (or 59%) of all in-force policies were those purchased individually (as opposed to group coverage obtained through employers or credit coverage obtained to repay a specific loan). Given the large dollars involved, and the importance insurance plays in providing for family members, it would seem that policyholders should be paying attention to the insurance they own. Unfortunately, that is not typically the case. I am often amazed at the number of clients who sheepishly admit to their lack of knowledge and understanding of their policies.

Many people nearing or in retirement have life insurance policies they have not thought about in years. If this is your situation, now is the time to act. You may be unnecessarily paying premiums or you may not be paying enough in premiums to maintain the policy. You may have more death benefit than you need. Perhaps the policy has built up a sizeable cash value which could be used to fund a new business venture, pay for a family vacation, or convert to a policy that provides for long-term care expenses. You may mistakenly think you have $1,000,000 of coverage only to learn one of your policies expired. It could be that the beneficiary designated on the policy is an ex-spouse or a family member with whom you no longer have a relationship.

To get started, take a basic inventory of your existing life insurance policies. Identify the following:

- <u>For all policies:</u>
  - Insurance company
  - Type of policy –term, variable, universal, or whole life
  - Name of the policy owner and name of the insured
  - Primary and contingent beneficiaries
  - Death benefit (the tax-free amount paid to beneficiaries upon the death of the insured)
  - Rating at the time the policy was issued (basic classifications for non-smokers - select, preferred, and standard, and for smokers - standard smoker and preferred smoker; classifications are based upon your medical, non-medical, and financial risk factors from your life insurance application; the classification names may differ by company)
  - Premium amount and payment frequency (monthly, quarterly, annually)
- <u>For permanent policies (variable, universal, and whole life):</u>
  - Cash value (the total amount of premiums paid less policy expenses)
  - Whether the premium was projected to remain level, increase or decrease over time, or end in a certain year
  - Is the death benefit guaranteed?
  - If you own a whole life policy, how the dividend is applied (dividends represent a portion of the insurance company's profits that are paid to policyholders, similar to how dividends are paid on shares of stock; dividends can be received in cash, used to purchase additional death benefit, set aside in an interest-bearing account with the insurance company, or used to offset the policy premiums.)

For term policies:

- Policy term (when does the policy terminate)
- Type of term coverage (level – a set premium for the same death benefit for a set number of years (the "term"); annual renewable term – an increasing premium for the same death benefit which renews each year; decreasing term – a level premium for a set term with a decreasing death benefit
- Whether the policy is convertible to permanent coverage

Once that information is gathered, it will likely raise a number of questions, a sampling of which are addressed below:

1) What if you have term insurance that will soon be expiring and realize that life insurance coverage is needed for a longer period of time?

   Many people purchase 20 or 30-year term life insurance policies when their children are young assuming that death benefit will not be needed once the children are grown and out of the house. However, life throws curveballs and it is not uncommon for insurance to be needed later in life, perhaps to pay off a large business debt, a home mortgage that was refinanced to help pay for a child's college education, or to serve as an extra safety net for a spouse who is not eligible for long-term care insurance.

   Review your term policy to determine if it includes a conversion feature, which allows policyholders to convert the policy from term coverage to permanent coverage, typically without a medical exam. Then, check to see if you are still within the window to make the conversion (conversion features have an expiration date). If you are still within the window, contact your advisor or the insurance company to determine the cost of the permanent insurance and the death benefit. If you were a smoker when you first purchased the policy, and have since quit, make sure to ask how you can qualify for nonsmoker rates. At the same time, obtain pricing information for a new policy with a similar death benefit so that you can make a comparison.

   If you are not eligible to convert the policy, obtain quotes on new insurance. Even before you meet with an advisor or agent, give some thought to your life insurance need. Do you only need the insurance to cover a certain period of time, for example, until the home mortgage is paid off or a college education is paid for? Are you looking to obtain the maximum amount of life insurance for the lowest cost (typically a term policy), or you are looking to build both cash value and death benefit (a permanent policy). Keep in mind that while individuals in their 70s and 80s can purchase new insurance policies, it comes with a significant cost as age and health are two primary factors in insurance pricing. In addition, many companies will not issue term coverage to individuals of a certain age.

2) What if you have permanent insurance (universal, variable, and whole life), have been paying premiums for years, and have no idea if the policy is still appropriate for your situation or is performing as expected.

   Permanent life insurance requires more due diligence than term insurance due to its complexity. Often, clients learn too late that the policy has not performed as originally projected and the death benefit and/or the policy duration have changed (and, generally not for the better). This has been a particular issue of late because the projections for older policies were based on interest rates that were substantially higher than today's rates. As a result, the underlying cash values of the policies have not increased fast enough to support the death benefit. Many policyholders have been surprised to learn that in order to maintain the policy, they need to start paying premiums again, increase the premiums they are paying, or pay premiums for a longer time

Take the time to request an in-force illustration (sometimes referred to as a ledger) which is a picture of how the policy is performing given current interest rates, premiums, and charges. It is also helpful to request an illustration which shows how the policy would fare if the interest rate were to drop to the minimum (assuming the current rate is higher than the minimum rate) and mortality rates stay the same. If you no longer have a relationship with the agent from whom you purchased the policy, you can call the insurance company directly.

Insurance illustrations are generally complicated and not easy for most people to decipher. I recommend that you meet with a trusted advisor to review the illustrations. He or she should clearly answer all of your questions, explain the pros and cons of the policy, and, if applicable, provide you with options to the existing policy. Although it can be time consuming and for some, uncomfortable, obtaining the opinion of more than one advisor should be considered.

3) What if you have permanent insurance and identify that the death benefit is no longer needed?

Although many policyholders don't realize it, there are a number of options available for a permanent life insurance policy that may no longer be needed. Often, policyholders don't ask for options and just stop paying the premium. Instead, policyholders should consider one of the following:

a) Surrender the policy – Surrendering the policy is another way to say the policy will be canceled and the remaining cash value returned to the policyholder. If the remaining cash value is less than the policy cost basis (the value of the premiums paid), surrendering the policy should be a tax-free event. However, if the cash value is greater than the premiums paid, the differential will be considered earnings and treated as taxable income. The insurance company can provide you with the total value of the premiums paid and the current cash value.
b) Take a loan from the policy – If the policy has substantial cash value, one option is to borrow the cash from the policy. If the withdrawals are structured properly, there should be no income tax impact. One common misunderstanding policyholders have is that they believe they are "borrowing" from themselves via the cash value they have built up by paying premiums. When withdrawals are made from the policy, the life insurance company is actually loaning the funds to the policyholder and the cash value of the policy serves as the collateral. The loan interest rate is not paid to the policyholder; it is paid to the life insurance company. If the policyholder does not pay the loan interest, the accruing amount is added to the balance of the loan. When the policyholder dies the loan is paid back in full to the insurance company before the net proceeds are distributed to the beneficiary. Before taking a loan from the policy, contact the insurance company to request an illustration showing the impact on the policy of the withdrawal(s).

c) Exchange the policy – Under Internal Revenue Code ("Code") § 1035(a), a policyholder may exchange a life insurance policy for a new similar life insurance policy, a non-qualified annuity, or a qualified long-term care insurance policy (not all policies are considered qualified) in a tax-free transaction. These exchanges, commonly referred to as "1035 exchanges" can be complicated and should be thoroughly reviewed before making a final decision.

4) What if you have permanent insurance and still need to pay premiums to keep the policy in force or it will soon lapse?

I was recently speaking with a client who has two small life insurance policies from the early 1980's. He does not need the death benefit, the cost basis is less than the premiums paid so if he surrenders the policies he will have taxable gain (which he wants to avoid), and if he stops paying the small premiums, the policies will likely terminate in the next few years. His initial thought was to just stop paying the premiums and let the policies expire.

Instead, he is now considering converting the policy to a guaranteed, reduced paid-up benefit policy. Assuming the cash value of the policy can support it, the death benefit can be converted to a guaranteed reduced amount with no additional premiums due.

Another option for some policies is to reduce the death benefit without a guarantee. While similar to the above option, the life insurance company may allow for a reduction in the death benefit and a related reduction in the premium, but neither the benefit nor the premiums are guaranteed.

A few final thoughts…don't cancel an existing life insurance policy before you have weighed all of your options, especially if you still need the coverage. Open all communication you receive from the insurance company. Yes, it is annoying to receive sales and marketing literature, but you don't want to miss important and time-sensitive information about your policy. If you are thinking about replacing an existing policy with a new policy, seek out the advice of an objective third-party who will not be compensated by selling you a new policy.

Although a life insurance review is not going to win any awards as a fun and exciting way to pass an hour or two, the time spent to evaluate your policy(ies) and understand what you are paying for will be well worth it in the long run.

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