LIFE INSURANCE PROBLEMS AND SOLUTIONS: A "NON-AGENT" PERSPECTIVE[1]

By: Richard B. Freeman, CFP®

Life insurance can be an important component of a comprehensive financial plan. However, problems related to life insurance can arise for a variety of reasons: client needs and tax laws may have changed; policy performance may not have met expectations; or the client may have purchased policies without fully understanding the product or their insurance needs. The solution to an insurance problem too often involves being sold a new policy or doing nothing. This typically happens when clients rely on an insurance agent for a solution or an advisor who has not explored all the available options—often because they are not paid to do so or do not have the expertise. The scenarios below identify some of the common problems related to life insurance and provide solutions from a planning perspective rather than a product perspective.

LIFE INSURANCE PROBLEMS

The "solution" to a life insurance problem too often involves being sold a new policy or doing nothing. Approaching life insurance from a planning perspective provides the best possible solutions.

PROBLEM: A hodge-podge of policies accumulated over the years that result in inefficiencies and a mismatch between client needs and in-force policies. Clients are not sure that their current portfolio of policies makes sense.

SOLUTION: As a first step, examine the client's planning situation assuming that there is no current insurance and determine current insurance needs and appropriate insurance products to meet those needs. If healthy, there may be attractive options to replace existing policies with better policies to meet the client's current needs. If insurability is a concern, more weight must be given to the current policies as any changes are considered. Advisors often approach this problem by trying to identify the

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“good” policies vs. the “bad” policies according to some subjective criteria. Then they keep the good ones and get rid of the bad ones. This approach does not take into account the fact that the client’s needs may have changed significantly since the original policies were purchased and assumes that the current policies were appropriate at the time they were purchased.

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PROBLEM: Under-performing permanent insurance policies that may require future premium payments that are greater than expected. For policies that were issued in a higher interest rate environment, a certain amount of premiums were projected to maintain the policy. Now that interest rates are lower, additional premiums may be needed in order to maintain the same coverage. Failure to pay increased premiums can result in an unexpected termination of the policy. Clients are often surprised and upset—blaming the carrier or insurance in general. This anger is misplaced and unproductive as the policy is doing what it was designed to do. Most likely the agent failed to explain (or the client forgot) how the policy works, and no one provided periodic updates to keep the policy owner informed.

SOLUTION: Re-assess client needs, review current policies to assess the degree of this problem and determine whether the policies should be replaced, re-structured or left alone. While the insurance company typically sends out annual statements showing policy values they do not send the necessary re-projections (called “in-force projections” in industry terms) needed to properly monitor the policy. A review should be done every two to three years. This can be especially problematic where a fiduciary relationship is involved via an Irrevocable Life Insurance Trust and the policy owner is a Trustee. If a Trustee fails to monitor the policy over time and it underperforms, the Trustee may be the target of legal action or at the very least a strained relationship with the insureds. Once again, rather than focusing exclusively on the product problem, this is an opportune time to revisit the planning area. Does the need that this policy originally fulfilled still exist or has it changed in any way? The client may have more assets, fewer expenses or lower estate tax exposure. Can this policy be restructured—maybe by lowering the death-benefit which will then limit the need for additional premiums? Finally, can a newer policy with lower cost-of-insurance rates or guaranteed premiums be purchased to meet the client’s needs.

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PROBLEM: Using a life insurance product to provide retirement income. High income earners may seek tax-advantaged ways to save for retirement. Life insurance sales illustrations that show how life insurance can meet that objective may look attractive; however, high premium payments may become burdensome over time. Policies often cannot be maintained and may not perform as projected.

SOLUTION: The best solution is to avoid these plans in the first place. Properly structured, the tax and policy aspects of using life insurance as a retirement income tool can look very attractive. Cash values grow tax deferred and may be accessed in retirement on a tax free basis using tax free withdrawals and loans. Combining high premiums with the smallest death benefit needed to maintain the tax benefits of life insurance maximizes the efficiency of this strategy. Growth of cash values are maximized while insurance costs are minimized. The illustrations show these plans needing a very long time to work well—perhaps 30 years or so. People start off by funding the policy as it was sold to them. But things change. Client income may have gone down—limiting funds available to commit to this strategy or they lose interest in paying the large premiums necessary to fund these plans. In addition, planning needs may have changed and the client no longer has a need for the death benefit. If the policy underperforms there is a risk that the policy will run out of money (lapse) at older ages. Allowing the policy to lapse could result in an income tax liability (on the deferred earnings). Even worse, if too much cash was already distributed, there may not be enough money in the policy to pay the tax (a/k/a "phantom income"). Most advisors rarely see anyone in retirement using a policy to provide income.

If a client has already purchased a life policy for retirement plan purposes and wants to stop using it that way several options are available. A first step in the assessment is to determine any surrender charges that may exist now and over the next few years if the policy is surrendered. Next, the policy may have a built up tax liability should it be surrendered—"taxable gain upon surrender" in industry terms. Finally, the insured's health and life insurance death benefit needs must be considered. After these factors are taken into account the insured could decide to keep the policy for death benefit purposes but reduce the high premium payments or just cash surrender the policy.

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PROBLEM: Assuming there is nothing you can do about an outdated or poorly drafted Irrevocable Life Insurance Trust (ILIT) that owns a life insurance policy. A trust that was drafted many years ago may be inconsistent with the client's current estate plan.

SOLUTION: There are several possible solutions to this problem:

(1) Decanting ("pouring" the contents of an old ILIT into a new ILIT) can be a solution where state law permits.

(2) Implementing a new policy with a new ILIT. When the ILIT holds term life insurance and the client is insurable, this can be an attractive option. While the new insurance may cost more—because the client is older now—that is often a cost worth incurring in order to have a new ILIT that is coordinated with the client's current estate plan.

(3) If a client is uninsurable, perhaps other policies exist that can be transferred into a new ILIT. Please note that the insured would have to survive three years after the date of transfer for the policy to escape estate taxation.[2]

[2] Transfers made within 3 years of death are included in a decedent's gross estate under IRC Section 2035.

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PROBLEM: High embedded taxable gain in a permanent life policy that is no longer needed. Surrendering the policy will result in taxation at ordinary income tax rates and could result in a large income tax liability.

SOLUTION: The first step is to contact the carrier and ask for the "taxable gain upon surrender" figure which will allow you to determine the income tax liability should the policy be surrendered. Once the tax liability is determined, the following options could be considered:

(1) Surrender the policy for its cash value and pay the tax.
(2) If the policy is owned by the insured then a tax-free rollover (IRC Section1035 exchange) to a no-load variable annuity might make sense. Taxation is deferred and investment options are increased.
(3) If the policy is owned by a trust and the beneficiaries are in a lower income tax bracket than the ILIT or Grantor it may make sense to distribute (if the trust permits) the policy to the beneficiaries and have them surrender the policy.
(4) Sell the policy on the secondary market through a Life Settlement broker.[3]

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PROBLEM: Buying less life insurance than you need because you are not spending your insurance dollars efficiently. Clients often have a maximum amount that they are inclined to spend on insurance. They tend to buy large 20 or 30 year term life insurance policies that have high premiums.

SOLUTION: Clients should consider layering policies into both shorter and longer periods to stretch their insurance dollars further. Owning some policies at the shorter end—10 or 15 years—can lower the overall cost as these policies have lower premiums and provide higher death benefits when financial obligations are highest. This strategy takes on increased relevance when clients are buying insurance in their late 30s and older. When you are young life insurance is generally inexpensive. As you age costs increase. This makes sense for many, as most families need less insurance (as the short term insurance ends) because their net worth builds and their financial responsibilities toward raising their children decreases.

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PROBLEM: Failure to insure a spouse that does not work outside the home. A high earning spouse may earn enough to afford a caretaker if the stay-at-home spouse dies and may not feel there is a need to insure a stay-at-home spouse.

[3] Note that income taxation may be ordinary income and/or capital gain.

SOLUTION: A few million dollars of 10 or 15 year term insurance will provide the working spouse greater flexibility in the event of an untimely death of the stay-at-home spouse. This can provide "walk-away" funds that will allow the bread-winner to take on a less demanding career and be available to the children. The cost of this insurance is often quite modest.

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CONCLUSION

From a practice management perspective, it is always a good idea when you give advice on life insurance coverage to secure an acknowledgement from a client that you have done so. This may involve the recommendation to increase, decrease or eliminate coverage. The client should acknowledge that they are aware that the death benefit will decrease or be eliminated and are in agreement with the recommendation. Even recommending an increase in coverage should be documented to cover the risk that the client fails to take your advice. Beneficiaries who find out that life insurance was decreased, eliminated or recommended but never implemented may sue the advisor when someone dies. A signed acknowledgement from the client should be in place to protect the advisor.

Life insurance is often an important component of a comprehensive financial plan. Because insurance is often sold as a product and not as part of a well-thought-out plan, a variety of insurance problems can accumulate over time. Likewise, the solution to these problems is too often approached from a product perspective. Approaching these matters from a planning perspective is more beneficial to clients. Life insurance opportunities exist and can provide creative solutions to a number of financial and estate planning problems.

ABOUT THE AUTHOR:

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