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Repurposing Life Insurance Policies

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Over the decades many families purchased life insurance, either to act as an income replacement vehicle when the breadwinner died, or to provide immediate liquidity to pay federal estate taxes on the breadwinner's death. With the 2017 Tax Act's temporarily doubled federal estate tax exemption amount to $11.4 million per individual, many believe that they no longer need to maintain their existing cash surrender value life insurance policies to pay federal estate taxes on their death. That conclusion may be accurate. Then again, surrendering an existing life insurance policy to access its cash surrender value may not be a wise move to make at this time. Before an existing life insurance cash value policy is surrendered, the policy owner should consider other options to repurpose the life insurance policy.

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The doubled federal estate tax exemption amount is only temporary. The doubled exemption amount will disappear in 2026. At that time, the transfer tax exemption is scheduled to drop back to around $5.5 million per individual. Added to this uncertainty as to the true amount of estate tax exposure is that many of the Democratic presidential candidates are pushing for a federal estate tax exemption amount of $3.5 million per person. It is possible that the federal estate tax exemption will be an even lower amount, and suddenly appear well before 2026 arrives. Consequently, a wait-and-see approach to dealing with existing life insurance policies makes a lot of sense if the purpose of the life insurance is tied to provide liquidity to pay federal estate taxes on the insured's death.

The next consideration is to explore repurposing the cash value life insurance policy, especially if the owner is now retired and the income-replacement features of the policy are no longer needed. Some possible new uses of an existing cash value life insurance policy include:

- Income Taxes: While cash value life insurance is not usually an effective wealth accumulation vehicle due to the normally high sales charges and the imbedded mortality costs of the insurance, there are several tax advantages that continue to make life insurance an effective wealth accumulation vehicle. If the policy is maintained in force until the insured's death, usually the entire death benefit paid is income tax-free. In contrast, if the insurance policy is surrendered and its cash value is recovered, the excess of the cash surrender value over the aggregate amount of premiums that were paid over the years is taxable as ordinary income to the policy owner. While the policy could be surrendered for its current cash surrender value, income taxes have to be figured in with regard to the net amount received. In short, simply surrendering the policy ought not be the first choice of the policy owner.
- Freeze the Death Benefit: Instead of a complete surrender of the life insurance policy, if the owner no longer wants to continue to pay policy premiums, it may be possible to 'freeze' the existing life insurance policy with no further premium payments, thus freezing the death benefit to be paid. However, with no future premiums paid, the death benefit would then be lower, but those reduced death benefits would still be income tax-free on the insured's death.

- Tax-Free Exchange: If the policy has been in-force for several decades it may have features or inherent mortality expenses that are no longer competitive with current rates. It is possible to engage in a tax-free like-kind exchange of life insurance policies (the exchange from the existing insurer to a new insurer) to convert the old, stale, policy to a new policy. The new policy might even provide a larger death benefit, or one with new benefit guarantees that did not accompany the old policy. Alternatively, the new policy may offer a much older maturity date as to when the policy ends, e.g. going from age 100 to 121 at the same or possibly a lower cost. In short a more efficient life insurance policy might be obtained through a life insurance policy exchange under IRC 1035 that provides the same death benefit but at a lower cost.
- Sale of the Policy Under a Life Settlement: The life insurance policy might be sold in a life settlement transaction in a secondary market for more than the policy's current cash surrender value. The price paid could be more than the cash surrender value but less than the death benefit that will be paid under the policy's terms. These sales are usually with regard to insureds who are over the age 65 and who have some health problems. Some types of insurance policies are more likely to be the subject of a 'sale' while others types will attract less interest by buyers. While initially these transactions dealt with policies with a death benefit of more than $1.0 million, currently policies with smaller death benefit commitments are now more commonplace. If an existing cash surrender value policy is 'sold' (not surrendered) to a third party, the price received is taxed using the following principles: (i) the cost basis (premiums previously paid by the policy owner) are income tax-free; (ii) the difference between the policy's cost basis and the policy's current cash surrender value is taxed as ordinary income to the owner; and (ii) if the policy owner receives more than the current cash surrender value as the sales price, the excess is taxed to the owner at capital gains tax rates. While life settlement transactions admittedly had a relatively sordid early history, they are now subject to a highly regulated financial market that requires many disclosures and imposes fiduciary principles to protect selling policy owners.
- Long Term Care Substitute: We all worry about escalating long-term care expenses in our retirement years. While long-term care insurance policies are available to be purchased, they are very expensive to maintain. Consider that John Hancock, Mass Mutual and Genworth have each raised their long-term care insurance premiums by 60%-to-70% in recent years, in turn causing many insured to reconsider the continued use of long-term care insurance policies. The other drawback to the purchase of a long-term care policy is the possibility that the policy owner will spend thousands of dollars in premiums on a long-term care insurance policy that he or she will never use. The insurance industry has responded to this concern. Many life insurance companies now sell life insurance products that combine life insurance with long-term care benefit riders to pay for expenses that Medicare and private health insurance do not cover. The amount that is not used to pay long term care benefits ends up being paid to the life insurance policy beneficiaries on the insured's death with the death benefit reduced to reflect the lifetime long-term care expenses paid by the policy. Such a policy might be obtained through a life insurance policy exchange, or perhaps the existing policy could be sold in a life settlement transaction with the sales proceeds used to purchase a new life insurance policy with a long-term care rider.
- Retirement Income: If the policy owner is concerned about outliving his or her income in their retirement years, in a policy exchange, the life insurance policy can be exchanged for an annuity policy that will pay lifetime

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income to the annuitant. Like a surrender of the cash surrender values, the premiums previously paid for the life insurance policy are returned tax-free with the balance of the monthly annuity payment being taxed as ordinary income. While there are substantial commissions normally associated with the purchase of an annuity, it is possible to avoid exorbitant commissions if the existing life insurance policy is exchanged for a lifetime annuity.

Every couple of years the policy owner should request in-force illustrations from the issuing insurance company with regard to the life insurance policy in order to re-project the policy's expected performance based on current and guaranteed values. Policy illustrations with different premium payment options should be requested from the insurance company to demonstrate projected outcomes under various premium payment scenarios, including how long before the policy would lapse if the owner ceased to make any further premium payments.

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It is estimated that Americans lose $112 billion in death benefits each year merely by lapsing their existing life insurance policies or surrendering their cash value life insurance policies. While the original purpose to purchase a life insurance policy may have changed, and perhaps the need to maintain the policy no longer exists, it could be premature to terminate or surrender an existing life insurance policy without first considering all options. An existing policy might be sold for more than its current cash surrender value in a life settlement transaction. An existing policy might be repurposed to obtain long-term care benefits. Or an existing life insurance policy's cash surrender value income tax-free (up to the amount of premiums paid over the years) could be used to supplement retirement income. Just because an individual's estate tax exemption amount has been doubled for the next several years is not a good reason to terminate an existing life insurance policy. Explore your options and then make an informed decision before you surrender a policy and cash it in.