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When it Comes to Life Insurance, "Permanent" Does Not Mean Unchanging

By Richard M. Morgan & Loraine M. DiSalvo

Life insurance comes in two very basic types: term insurance and permanent insurance. Term policies, the most common kind, usually provide only a death benefit and do not provide any cash or surrender value. Term policies are generally best suited only for a fairly short-term insurance need, such as 10, 20, or 30 years. At the end of the term, the policies are generally allowed to lapse. Permanent policies, on the other hand, provide both life insurance coverage and a savings or investment component: the policies are designed to build value inside the policy, which can be accessed by the insured during her lifetime through loans or if the policy is cancelled. The "permanent" in "permanent insurance" is a reflection of the fact that the policies are generally intended to remain in place for the rest of the owner's life, instead of only for a set period of years. What "permanent" does not mean is that the insured person should purchase the policy and then ignore it. Instead, it is critically important to ensure that a permanent policy is reviewed every so often. A periodic review can help ensure that the policy is performing as expected, and can help avoid nasty surprises.

A life insurance policy, especially a permanent one, is basically a very long-term contract with an insurance company. The insurance company wants to make a profit on your contract. Historically, life insurance companies tended to be set up as mutual companies, which are owned by their policyholders. This mutual company structure tended to help protect the interests of the policyholders in many ways; in part, because mutual companies were legally restricted from treating their policyholders in certain ways, and in part, because the policyholders were the ones who had to be kept happy, not third party shareholders. However, in the not too distant past, many mutual companies converted themselves to publically traded stock companies. This freed the companies from some of the stricter regulations and also created the need for the companies to ensure that their shareholders, who may not also be policyholders, are happy.

Former mutual companies that became stock companies gained, among other freedoms, the ability to raise costs on particular existing groups of policies, while keeping costs as low as possible on new policies that they wished to sell. On May 20, 2016, *The New York Times* published an article, "Rising Premiums for Universal Life Insurance Draw Scrutiny". This article discusses just such a situation. The article mentions that Consumer Watchdog, a California-based advocacy group, recently filed suit against Transamerica Life Insurance Company for breach of contract on behalf of holders of older universal life policies. Universal life insurance is a type of permanent policy in which the cash value is increased each month by the difference between the premium paid and the actual cost of the underlying insurance. Unlike more traditional whole life, the premium can be a higher or lower amount, selected by the insured, and the cash value can often be used to make the premium payments, allowing the insured to effectively skip premium payments without causing the policy to lapse.

Under the policies at issue in the Consumer Watchdog lawsuit, which were issued when interest rates were much higher than they are now, Transamerica was supposed to credit policyholders' cash values with a certain minimum amount of interest. Premiums and other costs were supposed to fall within certain ranges. The lawsuit alleges that Transamerica has been increasing the amount deducted each month from the policyholders' accounts for the insurance, to effectively offset the interest credits so that the net interest actually credited is less than the minimum amount promised. Consumer Watchdog alleges that Transamerica is trying to impermissibly put the burden of the losses Transamerica has suffered on these policies on the policyholders. Transamerica denies any breach of contract or other wrongdoing, and the case is only in the beginning stages.

Transamerica, like many other companies that issued universal life policies in the past when interest rates were high, has also recently announced very large premium increases for these older policies: 38% on average, and higher in many cases. Many policyholders have had their policies for decades, were using them as investments as well as for life insurance coverage, and are now facing the loss of the policies as the premiums increase to unaffordable levels. They are now facing the following choices, some of which may be impossible and some of which may have very unpleasant consequences: (i) pay the higher premiums, even if it means cutting out other spending or postponing retirement; (ii) continue to pay lower premiums and take the risk that the higher monthly deductions taken by the insurance companies will eventually cause the cash value to become depleted and the policies to lapse; (iii) restructure the existing policies, if possible, to reduce their premiums while also reducing the risk of their eventual lapse; (iv) exchange the existing policies for one or more other policies in a tax-free Section 1035 exchange; or (v) simply cancel the policies, take whatever cash value is available, pay the income taxes that may be owed when the policy is cashed out, and try to reinvest the remaining cash, if any, elsewhere or replace the death benefit with another policy. **Please see below as to the significant negative tax consequences that may result where a permanent policy is terminated or allowed to lapse.**

Situations like the one discussed above will likely become more and more common. Policies that were issued when interest rates were high, especially in the 1980s and 1990s, tended to be based on assumptions that involved interest rates remaining at similarly high levels indefinitely. In our current environment of historically low interest rates, preceded by years and years of declining interest rates, these old policy projections mean that policies that were expected to be profitable are providing little or no profits for the issuing companies. These companies are going to keep looking for ways to address this issue.

What can policyholders do to help protect themselves?

1. **Find a great life insurance agent, and use his or her expertise.** Find a great life insurance agent. Have the agent help you review your existing life insurance polices, to see if any changes are needed or desirable and whether policies are in danger of failing. When seeking

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new or replacement insurance, have the agent help you carefully consider what companies to work with. Not all life insurance companies are equal. A good, experienced, agent should be able to help you determine the better companies.

You should also have the agent help you determine the best type of policy to purchase for your particular needs, especially if permanent insurance is needed or otherwise desired. Term life insurance policies normally only come in two flavors: annually increasing term, where the premium increases annually along with your risk of dying as you age; and level term, where you pay a fixed amount each year for a set period, such as 10, 20, or 30 years, and for which the annual premium tends to go up significantly at the end of the set period. Term insurance polices can provide the option to convert the term policy into a permanent policy at a later date, with the rating for the permanent policy to be based on your health status as of the date you purchased the term policy, which can be a potentially significant benefit. Term policies that carry a conversion right are sometimes called “convertible” term.

While term polices are fairly simple, permanent life insurance polices come in many more flavors, each of which has its own details, pros, and cons. When considering permanent insurance, you really need the assistance of a competent and ethical life insurance agent. And, depending on the reason you are buying the insurance, you may really need a permanent policy, instead of a term policy. This is because permanent polices are designed to help ensure that the death benefit will be available whenever you die, while term policies are really intended only to pay a death benefit if you die prematurely. If you are trying to ensure that a buy-sell agreement can be funded whenever you die, or that a special needs child’s care and support can be provided for, or that liquidity will be available to your estate for taxes or other cash needs after your death, permanent insurance is generally going to be more desirable than term, because it helps ensure that the benefit will be there no matter when you die.

Finally, when considering the purchase of a permanent life insurance policy, you need to consider not just the premium and death benefit amounts but also the policy guarantees and the flexibility of the policy in the future. For example, the least expensive permanent policy may have lower premiums, but it may not accumulate cash value as quickly as a policy with a slightly higher premium. The lower premium may sound good when the policy is purchased, but with lower future cash values, you may have more limited future options for dealing with the policy. Your insurance agent should help you consider all of these options.

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2. **Get "in force ledgers" for any existing permanent life insurance policies, and have the policies reviewed periodically.** People who hold existing permanent life insurance policies can request an in force ledger for each of their policies. The in force ledger provides a lot of status information with regard to the policy, and can provide helpful insight. Your insurance broker should help with this. It may also be good to get an occasional review from a different broker, as a second opinion.

3. **DO NOT simply allow a permanent life insurance policy to terminate or lapse; you must first carefully determine what the income tax consequences will be.** As discussed above, one option faced by the holder of a permanent life insurance policy on which the premiums have increased is to terminate the policy or let it lapse. **Please note: you should NEVER let a permanent life insurance policy terminate or lapse without first figuring out what the income tax consequences will be.** While the investment returns generated inside the policy are generally not subject to income tax as long as the policy remains in effect, there can be significant income tax consequences if the policy is terminated or allowed to lapse. If the insured has borrowed against the cash value of the policy or used the internal earnings to pay the on-going life insurance premiums prior to the termination or lapse, these tax consequences can be extremely unfavorable. Before allowing a policy to terminate or lapse, you MUST first know what the tax consequences will be, so that you can then figure out what, if anything, can be done to prevent or at least reduce the negative tax consequences. While the *New York Times* article discussed above does mention letting a policy lapse as an option available to policyholders, it failed to discuss the possibility of significant negative tax consequences.

   The IRS and the federal courts state that when a permanent policy terminates or lapses, it is treated, at least to some extent, as if the policy were actually sold. The taxable gain on the deemed policy sale is then determined by comparing the total amount that the insured paid toward the policy with the total amount that was earned inside the policy. The total earnings used in this calculation are **not** reduced by the amount of internal earnings that were borrowed or were used to pay policy premiums. This means that the total amount earned by the policy can actually far exceed the cash value received when the policy terminates or lapses. In effect, the policyholder can end up paying taxes on a significant amount of phantom income that he does not actually receive, often requiring the policyholder to use other assets to pay the taxes generated. The courts have also held that no hardship exceptions exist to allow a policyholder to avoid this result. **So, again, our advice is that you never, ever, let a permanent life insurance policy terminate or lapse before checking with the life insurance company to determine the resulting amount of taxable income you may be required to recognize.**

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We do not sell life insurance, and we are not the ones who should advise you with regard to the health or suitability of your existing policies. However, we have a lot of experience in dealing with life insurance issues, and we know many different life insurance agents and brokers. We are happy to provide referrals for people who want assistance with a policy purchase or review. For a referral, or for questions on how your life insurance may fit into your overall estate plan, please contact us at (678) 720-0750 or info@MorganDiSalvo.com.