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The Little Known and Understood Living Benefits of Life Insurance

By Henry Montag, CFP, and Bill Boersma, AEP

Life insurance is one of those things many people think they understand—you pay a premium, you die, and your beneficiaries collect a death benefit from the insurance company. But in reality most people understand very little about the subject. In fact, while gathering survey information regarding what consumers know about their own life insurance, we noticed that many respondents changed their initial answer to the first question, which asked for a self-evaluation of their insurance knowledge, once they completed the 10 questions we asked. "I guess I don't know as much as I thought" was a very common response. Another interesting response we found from our sampling of questions was how few people knew that they could withdraw dollars from the death benefit of a life insurance policy to pay for their long-term care costs. More on that and the results of our opinion survey later. First, let us frame the intent of this article as seen through the lenses of the two authors who, with more than 75 years of combined experience, will discuss the lesser known benefits of life insurance that the attorney and ultimately his or her clients could benefit from being aware of.

Most people know that the major reason people buy life insurance is so that when they die, their family, business partners, or other beneficiaries will receive a check from the insurer. Most are aware that the proceeds from a life policy can be received tax free. Unfortunately, however, most people view life insurance as a stodgy document that you buy and put in a file drawer, only to be looked at when the insured passes away. That thinking worked up to the early 1980s when there were only two types of life insurance: term and whole life, which were both guaranteed. However, in the early 1980s when E.F Hutton created non-guaranteed Universal Life Insurance, everything changed. This article will focus on the fact that life insurance is also an "asset class" that can provide significant living benefits to an insured, and the owner, in addition to a death benefit that, with proper attention, is payable to their beneficiaries.

There are three specific types of living benefits that can be enjoyed by those aware and able to take advantage of them. As long-time practitioners we speak with experience when we say that only a small minority of policy owners and their advisors are aware of and understand many of the benefits we will be discussing. To further document this point, we created a short opinion poll to determine what the average consumer knows and doesn't know about their own life insurance policies. The results were very interesting, though not necessarily surprising. Realizing just how little policy owners understood about the basics may make it more compelling for you, their advisor, to realize the opportunity to not just draft the Irrevocable Life Insurance Trust (ILIT) and the Special Needs Trust (SNT), but to advocate for, and provide guidance to, the owner/trustee or insured of a life policy that's funding those vehicles.

It became apparent that so few understand this often misused financial tool that, as we'll see, is capable of so much more than just providing a death benefit. One of the most significant findings in our survey was the high percentage of individuals who purchased Universal Life Insurance policies and didn't know that there was a guaranteed and non-guaranteed version. Further, that many weren't aware that those life insurance policies were now in the process of expiring prematurely, as a result of reduced interest rates. Nor were a high percentage aware that they should have been actively managing those policies by increasing the premium paid to the life insurance company over the years.

The three living benefits we'll discuss are:

a. Life insurance and long- term care benefits resulting from the Pension Protection Act of 2006.

b. Utilizing tax-deferred accumulation benefits and tax-free distribution strategies to supplement retirement.

c. Utilizing Life Settlement strategies to maximize the value of an existing life insurance policy's living value.

Long-Term Care

The Pension Protection Act of 2006 (PPA), which was planned for in the early 2000s and first became effective in 2010, marked a change in public policy regarding paying for long-term care. Since the largest financial burden of paying for long-term care costs ultimately falls on state and federal governments, many governmental officials were seeking ways to increase the public's use of long-term care insurance, which had stalled out at a dismal 9-10% of market penetration. They were hoping to provide sufficient incentives to motivate their constituencies to procure private insurance themselves, rather than seek the counsel of an elder law attorney to help them shelter their own funds while going on the Medicaid rolls. In the early 2000s it was decided between the insurers and the federal and state governments that this would be accomplished by the creation of several new and significant tax benefits for those who purchased PPA-eligible hybrid, combo, or linked private long-term care, life insurance, and annuities.

The Pension Protection Act in 2010 allowed an individual to draw money from the death benefit of life insurance policies on a tax favorable basis for use in paying long-term care expenses. In addition, it allowed for the tax-free purchase of a long-term care insurance policy from the otherwise taxable gains of a life insurance policy's cash value, or an SPDA, single premium deferred annuity. The PPA also introduced a new crop of products that created significant leverage in creating a long-term care benefit that can turn $1 into three-five times greater than the initial lump sum deposited into one of these new classes of policies. These policies are referred to as asset based, combination, linked benefit or hybrid policies. In addition to the tax benefits and leverage, perhaps one of the most important benefits is that these products removed the 'use it or lose it' mentality normally associated with a traditional stand-alone long-term care insurance policy. Right up there with costs, the most popular reason for not purchasing long-term care coverage was the fact that if they never needed the coverage, they would have lost all of the premium dollars they had paid in over the years.

A hybrid LTC policy can be either a life insurance or annuity contract with a rider that offers long-term care benefits. For example, say a consumer buys a $500,000 life insurance policy with an LTC rider. When the insured individual qualifies for LTC benefits (typically when he or she is unable to perform two of six activities of daily living [ADL] or becomes cognitively impaired), a given percentage of death benefit, 2% in this example, is available each month for LTC needs. This means that 2% of $500,000, or $10,000, is paid out monthly. An annuity-based LTC hybrid policy would also have a ratcheted-up benefit for LTC purposes. Additionally, inflation protection and return of premium may be added.

Before the PPA the last-in, first-out nature of taxation for annuities meant that accessing cash value to pay for LTC expenses or LTC premiums was a taxable transaction for contracts with a gain. In some situations the cost of an LTC rider was considered a distribution and taxed as ordinary income. The PPA changes this. For example, if an annuity with significant gain is rolled into a new PPA-compliant annuity, the entire value of the annuity could be used to pay for LTC costs, and the taxes on the gain would forever be avoided. Annuities still can't be exchanged into life insurance contracts, though life insurance contracts can be exchanged into annuity contracts.

Another new aspect of the PPA is the ability to do a full or partial tax-free Section 1035 exchange into a stand-alone long-term care policy from a life insurance policy or annuity. This is another way to eliminate income tax on gain in the policies when pursuing long-term care solutions. For example, someone with a $50,000 gain in a $100,000 annuity would normally first have to pay taxes on the $50,000 gain. However, if the money was transferred via a 1035 tax-free exchange into a hybrid product, they could eliminate the entire tax on the $50,000 gain while leveraging the $100,000 principal into a much higher pool of dollars available to pay for long-term care costs, a very significant benefit.

Individuals today are able to place new money, or transfer existing annuities with an otherwise taxable gain, into a Single Premium Immediate Annuity (SPIA) and use the full proceeds of that otherwise taxable flow of income from the SPIA to pay for an individual's or couple's long-term care premium's. These single premium immediate annuity payments can also pay an existing long-term care policy's premiums on a tax advantaged basis, assuming the premiums are paid directly to the insurer from the annuity with no concern as to an individual's health or insurability. Another very important benefit has been the ability to lock in costs for long-term care premiums, and avoid the significant premium increases the purchasers of long-term care insurance have experienced over the last decade. These benefits, all the direct result of the PPA, have been responsible for an increasing number of requests from wealthy clients seeking information about these strategies, as well as a significant number of new life policies sold with these LTCI features and riders. How well have these combo plans been accepted by the consumer? According to the Life Insurance Marketing Research Association (LIMRA), in 2017 there were approximately 66,000 traditional stand-alone long-term care policies sold, and approximately 260,000 hybrid plans. The only downside is indeed ironic: that these combo plans cannot take advantage of the various tax credits that traditional stand-alone plans are entitled to.

Accumulation Planning

The second form of living benefit generically involves retirement cash flow. These are often referred to as private pensions, deferred compensation, salary continuation, supplemental executive retirement plans, 162 bonus plans and others. Fundamentally, each version is a form of richly funding a life insurance policy to build cash value over and above the expenses in the contract to grow tax free until a point in time where the cash value can be withdrawn and/or borrowed as a loan. Assuming the withdrawal strategies are structured correctly, the loans never have to be paid back, meaning the withdrawals can be 100% income tax free as long as a minimum $10,000 of the death benefit survives the insured. This concept can be implemented through a variety of contracts with varying risk profiles.

Fixed interest whole and universal life insurance to securities based variable life insurance to indexed life insurance, which is a bit of a hybrid product, can be used for accumulation purposes.

The benefits of using life insurance contracts for accumulation purposes include the fact that there aren't limits on contributions as there are in qualified plans; there is more flexibility in funding. Depending on product, plan design can be personalized and discriminatory; money can be accessed tax free and prior to age 59½ without penalties, and the death benefit itself is an obvious benefit. In many situations the policy's premium can be shared with the employer for a key person, or for the employer themselves through various cost sharing strategies such as a split dollar arrangement. In a split dollar arrangement a corporate dollar, usually in a lower tax bracket, can be used instead of the individual's higher tax bracket.

Potential downsides include the inherent expenses of a life insurance contract and the need for active management. There are clashing mentalities regarding the benefit of insurance funding accumulation planning with reasonable pros and cons on each side. Too often we see it presented as a panacea and over marketed with scant attention paid to properly choosing, building and managing programs and accessing money without professional guidance. However, when thoroughly understood and managed appropriately, well-constructed plans can provide much needed benefits, especially when the tax-free death benefit is a needed benefit.

Businesses often use life insurance as incentive plans to reward valuable and loyal employees on a discriminatory basis with the ability to maintain control if desired. It cannot be overstated how important it is to choose appropriate products, properly build individuals' contracts, fund them richly, and manage them actively. Realistic expectations of returns and benefits are crucial or both employees and employers can be left disillusioned. In worst-case situations, misunderstanding and mismanaged policies can result in catastrophic income tax consequences that will leave participants wishing they had never heard of the concept.

In the declining interest rate markets over the past decades, many insurance funded accumulation plans have failed to pan out. This is no different than a traditional retirement plan not panning out if returns do not meet original expectations; thus the need for management and a realignment of expectations. As opposed to traditional investments, where if returns and crediting rates are lower than expected there is still an account balance, with life insurance the entire contract may fail, wasting all monies that have been contributed.

None of this means the concept is bad, just that it is important to understand it thoroughly and work with skilled professionals to implement and manage strategies. Monies can be accessed through withdrawals as life insurance tax law allows basis to be extracted first, which is opposite to the rules regarding annuities. After basis is utilized, policy loans can be utilized to further access policy value and these loans, if in appropriate proportion to cash value, may not need to ever be paid back during life. While this is a major marketing feature of life insurance, great care must be taken to fully understand what this means, and the importance of modeling and managing the downside potential.

As with the long-term care options we discussed earlier, a life insurance policy that has outlived its purpose can also be exchanged tax free into an annuity product that may focus more directly on specific life insurance needs. Immediate annuities, deferred annuities, annuities with income riders, attractive death benefit features and long-term care options are all available. Furthermore, those not comfortable closely managing a life insurance policy to prevent some of the downsides from playing out can eliminate many of the risks through an annuity conversion.

College funding and any other potential need for asset accumulation where tax benefits and death benefit are advantageous could also be a consideration for the living benefits of a life insurance policy.

Life Settlements

Though our consulting practices, advisors are regularly asking us to analyze trust-owned life insurance for clients who previously purchased policies to provide liquidity to pay for their future estate tax liability. Many now feel that with the new federal tax law, which currently provides a $22,800,000 exemption for a couple, that their existing life insurance policies are no longer needed, although there are potential state estate issues to be considered. Whether that's a wise strategy or not is beyond the scope of this article and deserves careful consideration as the current law sunsets in only 5½ more years. Not to mention the current political climate that seems to favor a reduction in the current exemption levels. Nonetheless, we do the performance evaluations as we're requested.

Life insurance policies can advance through seasons of need and provide differing benefits that policy owners and insured individuals need over time.

Life settlements are an outgrowth of the viatical settlement market. A viatical settlement is a clause in a life insurance policy that allows an insured to collect a percentage of their death benefit while alive but only if they are certified to have less than six to twelve months to live. Unlike a viatical, life settlements are the sale of a life insurance policy to a third party on the life of an individual who does not have a terminal illness. Generally speaking, candidates must be in their seventies and beyond and offers are more attractive when the health of the insured has deteriorated.

Sometimes the policies are inadequately funded with severely declining cash values and may never pay a death benefit, and other times the cash value and premiums prove to be an un-duplicable use of money. Either way, policy owners and trustees need to ask the necessary questions to make the proper decisions regarding the best use of their life insurance assets, and the premiums that fund them. Sometimes the cash value from these policies is considered "found money" and redeployed into LTC protection. After all, the concept of risk shifting is still applicable to people with wealth.

When discussing life settlements the subject of legality needs to be clarified. Many consumers and advisors alike confuse Stranger Owned Life Insurance (STOLI), which is illegal, with a Life Settlement, which is legal. It's just like the sale of any other asset you own, a car, a house or a boat, etc.

Most of our work with life settlements has been the sale of non–guaranteed, underfunded and underperforming universal life policies where substantially more premium is required to keep the policies going or the death benefits must be cut. Let's say an older gentleman has a $1million policy that isn't projected to go to normal life expectancy due to years of declining interest rates and neglect. Premiums may have to be doubled or more to have a decent chance of keeping the policy afloat through life expectancy. Whether or not the life insurance is still needed, it should always be in the mind of clients and advisors to manage assets as astutely and efficiently as possible. This policy may have $50,000 of remaining cash value and be continuously decreasing and on track to expire in a few years, well before the insured individual is expected to pass. If a third party offer is available, and obtained at an amount greater than the cash value, it should of course be considered as it will extract the greatest value from the disappointing contract. Depending on age, health, type of contract, premium load and other issues, such a policy may be salable for double or triple the cash value, or even more.

Recently we worked a case where the parents decided that the children and grandchildren could benefit from the cash value of the life insurance policy today more than they could from the death benefit years from now. They were about to cash in the policy for the cash surrender value when we were introduced by their attorney. The upshot of this was that we successfully sold the policy on the market for more than the cash value, which allowed the heirs to obtain a larger payout than the existing cash value. In this situation the policy was all paid for, was guaranteed for life and was an excellent use of money.

Whether or not a client wants to take advantage of such a strategy, bringing it to the table, when appropriate, is of paramount importance.

Even term insurance policies can be life settlement candidates on occasion. There is a narrow path to a successful term life settlement as in almost all situations the term policy will need to be convertible, which is usually up to age 70 and in rare occasions to age 75. For an individual to be a candidate at that age, it is pretty much mandatory for there to be a meaningful negative change in health. That being said, selling a term policy, with no residual value, for even a low percentage of face amount may be attractive. In some circumstances we have seen hundreds of thousands, or even seven figures, become available out of thin air for an expiring asset few thought had any value whatsoever. It is especially important for advisors to make their business owner clients aware of this concept regarding their corporate-owned policies. Too often an old key-person policy, or a forgotten buy-sell policy, is simply lapsed at the end of the term when substantial value could have been realized. When companies are being bought and sold this is another way to find buried value. It's important to ask the questions, rather than discovering later that an opportunity was squandered.

In closing it should be noted that the authors highly approve of the implementation of Regulation 187 intended to protect the New York State life insurance consumer. In July of 2018 the New York State Department of Financial Services enacted legislation where for the first time the life insurance agent/broker will be required to not only do what is suitable for the consumer, but also do what's in the consumer's "best interest," and will also require full written disclosure regarding the risks of the purchase. (Regulation 187 has been re-named "Suitability and Best Interests in Life Insurance and Annuity Transactions.") The annuity provision becomes effective in August 2019, and the life insurance component becomes effective in February 2020. The authors feel it's high time that these new rules be imposed as they will provide more safeguards for the general public. It should be noted that credentialed members of Society of Financial Service Professionals and CFP certificants already have an imposed commitment to place the client's interest above their own, regardless of any recommendations or how they get paid. The CFP Board of Standards will begin enforcing a heightened fiduciary standard on its members effective October 1, 2019, which will then require the certificant to consider and analyze more than one potential course of action, and will require any suggestions to include the advantages and disadvantages of their recommendations. The new rules will now also apply to all advice and not just planning advice.

Bonus Idea

In most circumstances, when a life insurance policy is surrendered or lapsed, there is no ability to take a loss if the basis in the contract is greater than the surrender value. However, there are circumstances where that loss may be salvaged rather than wasted. Tax law allows a carryover of basis from a life insurance policy to an annuity. The ensuing annuity may grow tax free to the original basis. Alternatively, under the right circumstances, the annuity may be surrendered and the realized loss may be taken advantage of. These are strategies we will not discuss in depth here and warrant working closely with your tax counsel.

Life insurance is an interesting and very efficient yet complex financial tool. It is misunderstood by most people yet on a risk adjusted, leveraged and tax adjusted basis, no other financial tool can compare to its benefits. It is unfortunate that this lack of understanding too often translates into both lost, or at least not optimized, capital and missed opportunity through the living benefits we have discussed today. As the industry and market continues to evolve and competition drives innovation, the consumer benefit available through properly vetted, implemented, managed and divested life insurance will continue to grow and flourish. As mentioned the tools to properly manage and monitor these and other life policies to prevent their early expiration, and get the maximum value for one's premium dollars, are all available, they just have to be used. As good as life policies are, they don't come with a built in self-management mechanism, as that's the responsibility of the owner/trustee. All too often these individuals, usually the eldest son or daughter, have little to no knowledge of their responsibilities or liabilities. These amateur trustees, your next generation client, could certainly use your guidance and advocacy in these matters.

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Bill Boersma is the founder, owner and president of OC Consulting Group, a nationally operating life insurance consulting, audit, research and management practice in Grand Rapids, MI. Brought in by attorneys, CPAs, family offices, non-profits and financial professionals, OC offers expertise critical to proper procurement and ongoing management of life insurance assets as well as a track record of fixing problems. From mom and pop companies to billionaire families, engagements range from simple second opinions to in-depth, actuarial defensible analysis, building insurance portfolios to tearing them apart, independent modeling and stress testing, tax analysis, valuations, litigation support and expert witness work, life settlements...if it has to do with life insurance, OC has been there and delivered solutions.