Seven Reasons to Review Your Life Insurance Plan

Life insurance plans cannot be refinanced like mortgage plans, but they can be replaced.

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When interest rates fall, many of us consider refinancing our mortgages. We review the long-term savings versus the refinance costs and make a decision. Physicians can do this with their home mortgages, investment properties, and maybe even business loans. It is a common practice.

However, many physicians do not realize they can apply a similar cost-reduction and wealth enhancement strategy with another of their long-term assets: permanent (also called "cash value") life insurance. In this article, we explain why you should consider reviewing your life insurance as you likely have already done with your mortgage.

How Life Insurance and Real Estate Are Similar: Taxes

Although our tax code may change under a new president, real estate and cash value life insurance remain "tax-advantaged" asset classes, enjoying superior tax treatment over recent decades. With real estate, you can write off depreciation on business real estate, deduct interest payments on home mortgages, and enjoy up to a $500,000 capital gains exemption on the sale of your primary home, among other benefits. With cash value life insurance, you can enjoy tax-deferred growth of gains within the policy, while death benefits are generally paid to beneficiaries income tax-free.

Further, both can use a powerful tax benefit that few other assets are afforded: the ability to move from one piece of real estate/life policy to another using a tax-free-like kind of exchange. For real estate, these exchanges are controlled under tax code 1031; for life insurance, 1035. This shared tax benefit plays a role reducing long-term costs. A 1035 exchange permits moving from an existing policy to another (perhaps to lower costs or reap better distributions), without realizing built-in gains within the policy, and without any tax consequences.

How Life Insurance and Real Estate Are Similar: Variable Costs

Both real estate and cash value insurance have ongoing expenses like the interest cost of a mortgage for real estate and, with life insurance, the mortality cost of insurance (COI). These expenses accrue over time; the key is to monitor them and position yourself advantageously if the outside environment changes.

If interest rates fall below your current mortgage rate, you can refinance to take advantage of the lower rates, assuming closing costs will not completely eat up the savings. In some ways, this strategy is similar for cash value life insurance. You may be able to exchange your existing policy for a new policy that provides lower costs and/or better net withdrawals. It is a relatively simple analysis, but it helps to go a little deeper.

How to Exchange Plans

Unlike a mortgage, you do not actually "refinance" an existing cash value life insurance policy. You exchange it for a new one, using the 1035 exchange provision, as described previously. This is generally a simple process, but it usually requires new underwriting. Just as you would not refinance your mortgage if the closing costs are higher than the expected interest savings, neither should you exchange a policy for a new one if your health has worsened since you first acquired the policy. Of note, the costs of a new policy will likely exceed the costs of your existing policy.

With the help of a knowledgeable advisor, you can determine these factors in advance and model the numbers so that you have all the information before making the exchange. Note: if you have maintained a healthy lifestyle and remain in good health, there may be further financial incentive to exchange the policy.

Five Reasons to Exchange Related to Costs

There are five potentially cost-lowering reasons why owners exchange existing policies for new ones.

1. Industry-Wide COI Reductions. As a physician, you know people are living longer today. As a result, COIs have been dropping across the industry. Lower COIs mean lower insurance costs which mean better policy performance. If you began a policy over 10 years ago, exchanging into a new policy with updated COIs could be reason enough to see greater cash value growth and distributions in future years.

2. You Are Still in Great Health. Did you get a top rating when you received your cash value policy initially? Are you still in good health? If you answered "yes" to both questions, you may have the most to gain financially from a 1035 exchange because of the way insurance carriers price their policies. The carrier only had a snapshot of your health when they issued your policy (perhaps a physician's statement and blood/urine samples). They have no idea of your current lifestyle or health since policy issuance.

With such little information, and potentially millions of dollars on the line, it is not surprising that the carrier's internal cost accounting gradually diminishes the value of your "preferred" or "super-preferred" rating. After all, how do they know you haven't started smoking or gained a significant amount of weight?

The bottom line: if you can still qualify for a top underwriting rating, you may have the most to gain by exchanging into a new policy to "revive" a lower COI structure. Your cash values and distributions could benefit significantly.

3. Cost Structures Between Companies. Separate from the specific COI expense, insurance carriers vary in their overall product pricing structures, even within the top-tier companies. Because some carriers' products are known for more expensive cost structures, additional long-term cost savings can be gained by exchanging from one carrier's products to another.

4. Moving to Policies With Lower "Access" Costs. What are "access" costs? The most important one by far is the "net loan rate" the insurance carrier will charge you for borrowing from your cash values. Beyond your basis (what you paid in over the years as premium), you will likely want to borrow additional cash value against your death benefits to access your cash value while you are alive; that's what makes your access to these amounts tax-free. Thus, the loan rate your carrier charges is significant, and, unfortunately, often hidden by unscrupulous agents selling high-loan-rate policies. If you own a cash value policy, part of your strategy for doing so is likely to access those cash values, perhaps in retirement. If so, "access" costs are just as important as accumulation costs.

5. Moving to Mutual Companies. Some policy owners exchange their policies to those issued by mutual insurance companies, which are owned by the policyholders. The rationale is that they are more likely to get the benefit of future COI reductions or avoid future loan rate hikes (and other cost efficiencies) as owners of the company, as opposed to owning policies issued by stock insurance companies where these savings may just mean more profits for shareholders. For a long-term asset like life insurance, eliminating the conflict between shareholders and policy owners may be a wise decision.

Case Study: Doctor Dan Improves Performance Exchange to Different Product Types

Dan purchased a whole life insurance policy at age 40 from a large well-known carrier, and he is now 52. The carrier is very solid, as is their whole life insurance product, but it is also known in the industry to have relatively high expense charges. Dan was super-preferred when he initially purchased the policy and has maintained good health. Dan wanted to see how his whole life insurance policy would compare with a different type of policy, perhaps one with more upside on the investments and lower cost structures, taking advantage of COIs and perhaps a different company's product.

We modeled several scenarios for Dan. We found that, if he were to 1035 exchange his whole life policy to a universal life policy with another top-rated company, he would enjoy significantly improved performance. Insurance carriers do not publish their COIs for whole life products, but knowledgeable advisors can examine head-to-head performance numbers with identical ages, underwriting classifications, and assumed rates of return to see how the difference in distributions from the policy are affected, thereby comparing their underlying cost structures. For Dan, a 52-year-old "preferred" risk, and assuming a 5.85 percent rate of return for each policy, the results are quite dramatic. The distributions in his current whole life policy are projected to be $53,696 annually for 20 years starting at age 65. With the same assumptions, the distributions from the new universal life policy would be $98,476 annually for 20 years starting at age 65. This is nearly $45,000 of annual improvement, or nearly $900,000 of increased distributions over 20 years!

This dramatic improvement is due to the factors discussed in this article: 1. Likely improved COIs moving from the whole life product to the universal product (we don't use exact numbers here because, as mentioned, COIs for whole life products are not published); and 2. the improved costs of accessing the cash values in the universal life policy versus the whole life policy.

Two Reasons to Exchange Your Policies for Performance

In addition to lowering costs, many life insurance policy owners consider exchanging their policies because of investment performance. Let's look at two reasons.

1. **Taking Advantage of New Product Features.** How much more can your cell phone do for you now, as compared to 10 to 15 years ago? Although the differences in life insurance policies may not be as visually dramatic as your old versus new iPhone, they can be just as dramatic financially. Policy elements such as return multipliers, index participation rates, long-term care riders, and benefit distribution riders are new to the industry over the past few years and can be beneficial for the right client. If the underwriting rating has not changed, these factors alone may be attractive enough to justify a 1035 exchange.

2. **Moving From a Bond-Based Whole Life Policy to One With Some Stock Market Exposure.** Anyone following investments knows the last decade has not been kind to bonds and other investments that are based on interest rates. With the federal funds rate at zero percent (or close to it) from 2009-2016, many such bond-based or interest rate-based asset classes have underperformed. A whole life insurance policy is such an asset class, as its growth is based on an insurance company's dividend. With insurance companies' portfolios heavily bond-based, it is not surprising that most top-rated life insurance companies have seen their dividend rates decline steadily for the past decade. Rates have climbed a bit recently, but it may be a while before they rise enough to see whole life insurance policies return to what they yielded pre-2009.

As a result, for many clients looking for a decade or more of future growth in their policies, an exchange to a type of product that provides more upside than a whole life bond-based product may make sense. A description of these types of products is beyond the scope of this article but will be covered in the future.

Conclusion

Any physician who owns cash value life insurance should at least explore an exchange to a more efficient policy to determine if it would be more beneficial in the long run. Nearly all doctors review their mortgages and contemplate refinancing; an exchange is similar, and may work just as well. We encourage you to examine your options. ■

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