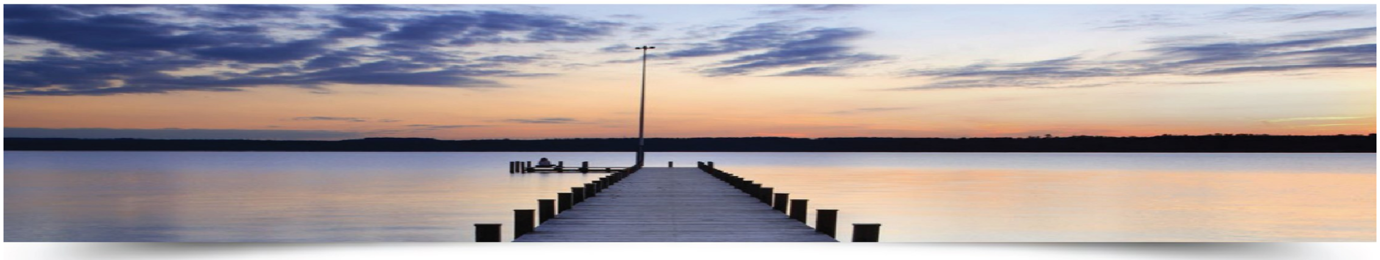

Should I Drop My Life Insurance?

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Many retirees do not need life insurance but that doesn't mean they should automatically drop their policies. During your working years, your family depends upon your income. In the event of an untimely death, life insurance would pay a tax-free income to the beneficiaries. This income replacement is probably the number one reason to have life insurance.

When you retire, you give up your employment income so many retirees have little need for that income replacement purpose. In addition, the estate tax exemption used to be low and many retirees had insurance to offset estate taxes. The exemption today equates to $5.3 million per person, so the use of insurance to offset these taxes has diminished.

Nonetheless, some retirees still find a need for life insurance. Common reasons include a reduced survivor benefit from a pension plan, the loss of Social Security payments when a spouse dies, and higher income taxes paid by widows and widowers. Widows and widowers file as a single taxpayer in the year after their spouse dies. When filing a joint return, taxable income above $73,800 is taxed at 25% or more (2014). For single filers, the 25% bracket starts at just $36,900.

Even if your life insurance policies are not needed, those policies are assets with value and shouldn't be disregarded. In some cases, doing nothing can be costly. One example is a policy with a loan balance. If a policy lapses with a loan balance, the owner has to treat the full amount of the loan as taxable income. Instead of a tax-free benefit, the owner gets a tax bill.

There are many options one can do with an unneeded life insurance policy. Below we share eight of the common uses:

1. Keep the policy - Death is a matter of "when", not "if". This simple fact gives rise to an old saying, "No beneficiary ever thought the deceased had too much life insurance." If the policy is in no danger of lapsing, your heirs should get whatever the death benefit will be. The obvious drawback to keeping the policy is additional premiums may need to be paid.

2. Surrender for the net cash value - This is a popular choice for those who cannot or do not want to pay premiums or repay loans to keep the policy in force. One issue to consider is if you cash out, your family will get nothing upon your death. In addition, while death proceeds from life insurance are usually income tax-free, you will be taxed at ordinary income rates, not the lower capital gains rates, for any amounts you receive above your cost basis in the policy. The tax bill can surprise the unwary and be significant, particularly if the policy has a loan against it.

3. Let it lapse - In some cases, the cash value is not enough to keep a loan-free policy in force for long, the basis in the policy is low, and the owner does not wish to make additional payments. Instead of cashing out and incurring the taxable income, some in this situation will simply let the remaining cash value fund the policy for as long as it can last on its own. If the insured dies before the policy lapses, the beneficiaries will receive the tax-free death benefit.

4. Employ a 1035 exchange - Cash values in a life insurance policy can be exchanged, tax-free, to an annuity contract or another life insurance policy. This is an attractive option for people who own an expensive or otherwise poorly designed policy. However, acceptable exchanges to new life insurance policies require the insured be healthy.

5. Sell it - Life insurance is an asset and can be sold. There are many companies that will buy a policy for more cash than a person would get if they simply surrendered their policy. Tax treatment is similar to cashing out. Taxable amounts are subject to ordinary income tax rates, not capital gain rates. The worse the insured's health, the more the policy will sell for, typically because the new owner is more likely to receive the death benefit sooner, boosting the return on the payment. Thus, one significant drawback to selling: if one is that unhealthy, the beneficiaries may be better off if other steps are taken to keep the policy in force.

6. Get some help - In some cases, we have seen family members fund a policy because an unhealthy insured was unable to do so. The death benefit more than makes up for the outlays. When this is done, it is critical that the beneficiary designations be correct.

7. Donate it - Like other assets, a life insurance policy can be donated to a charity and a charitable tax deduction received. Not all charities are equipped to handle all policies but it is a viable option.

8. Modify it - Some policies allow modifications like reducing the death benefit. Sometimes such a change will allow the policy to stay in force longer.

Each of these options come with their own twists and turns. How does one decide what to do?

The starting point is to get all the needed information to assess the "health" of the policy. We typically want to know the amount of the premiums, cost basis, and loans. We would request an "in force ledger statement" and a copy of the policy. Life insurance is an asset but it is also a contract with specific and usually complex provisions that dictate how the policy works, what the costs are, how the costs can change, and what and how modifications can be made by the owner or the insurance company.

This may all sound complex and maybe not worth the trouble. It is complex but we often find it is well worth the trouble to get the information and consult with any needed insurance agents. To maintain maximum objectivity, we work only for our clients and do not sell insurance. We have no incentive to favor a particular choice. As financial planners and independent fiduciaries, our interest is protecting our clients' interests and helping you make good choices regarding your finances.

ORLANDO OFFICE: 601 S. LAKE DESTINY ROAD, SUITE 165 | MAITLAND, FLORIDA 32751 | P: 407.869.6228 F: 407.869.6558
MELBOURNE OFFICE: 6767 N. WICKHAM ROAD, SUITE 215 | MELBOURNE, FLORIDA 32940 | P: 321.253.5400 F: 407.869.6558