Legacy Planning

What steps do you take when you inherit old universal life policies? **Richard Parkinson** explores different options

Universal life (UL) plans can be the most difficult plans to illustrate, primarily due to the vast amount of complex options for clients.

Take surrender charges. It is rare for me to find a client who purchased a UL policy less than 10 years ago, let alone 30 years ago, to have either been told about surrender charges or learned about them from the policy contract. The purpose of surrender charges changed somewhat under G3, i.e., post Jan. 1, 2017 rules, as the surrender charges will no longer have an effect on a policy's exempt room. So, one could argue that those companies that still have surrender charges on UL policies do so to try to discourage policy owners from cancelling them in the first five to 10 years.

Surrender charges were, pre 2017, for G1 and G2 policies, developed in part to allow an increase in the maximum annual deposit in a policy, yet still allow the policy to be exempt. Post January 2017, even though surrender charges no longer influence the exempt policy room, most companies have retained these surrender charges, but in some cases have reduced them. One company provides a table showing the surrender charges for their YRT, or level, and limited-pay plans, shown below:

PERCENTAGE OF TARGET PREMIUM			
Coverage	Annually	Level COI	Limited-pay COI
1	125%	125%	0%
2	200%	200%	0%
3	300%	300%	0%
4	400%	400%	0%
5	400%	400%	0%
6	400%	400%	0%
7	200%	200%	0%
8	100%	100%	0%
9	50%	50%	0%

Note that these charges for this company are based on the target premium, so for a policy with an annual premium of $1,000, in years four to six, the surrender charges are $4,000, and likely more than any cash value the policy will likely have. Make sure you advise the client upfront, and I also suggest highlighting the charges in the policy document or in a separate acknowledgement of sale details letter that the client signs, so there is no dispute five years later when the client asks for a review of their policy.

The YRT Conundrum

I've inherited several dozen UL policies that were written 20 to 30 years ago, and the original sales agent is long gone. Now the client is asking why they have to start paying a lot more in premiums to keep the policy going, and/or the policy doesn't have the cash value they were expecting.

Let's look at a recent case where the client bought a YRT UL policy back in January 1985 when he was 39 years old. Now in 2018 he is 71. As I do with all policies I inherit, I asked for an in-force illustration, which showed some concerning information. The summary of his policy was as follows:

Coverage Amount:	$100,000
Issue Date:	January 23, 1985
Age at Issue:	39
Current Age:	71
Annual Premium Paid Since Inception:	$1,400.00
Cash Value 2018:	$40,466.88
Annual Premium Required for Level COI:	$4,258.00

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And the detail from the in-force illustration showed the policy would lapse at age 84, or perhaps sooner if the rate of return was less than four per cent.

Coverage Year	Coverage Age	Assumed Interest Rate	Planned Premiums	Annual Charges	Fund Value	Cash Value	Total Death Benefit
30	71	4%	$0	$212	$40,519	$40,519	$140,388
31	72	4%	$1,400	$2,786	$40,987	$40,987	$140,050
32 7	3	4%	$1,400	$3,048	$40,819	$40,819	$139,060
33	74	4%	$1,400	$3,358	$40,327	$40,327	$137,737
34	75	4%	$1,400	$3,739	$39,427	$39,427	$136,002
35	76	4%	$1,400	$4,167	$38,053	$38,053	$133,800
36	77	4%	$1,400	$4,665	$36,125	$36,125	$131,061
37	78	4%	$1,400	$5,203	$33,561	$33,561	$127,713
38	79	4%	$1,400	$5,786	$30,298	$30,298	$123,708
39	80	4%	$1,400	$6,417	$26,260	$26,260	$118,985
40	81	4%	$1,400	$7,060	$21,404	$21,404	$113,519
41	82	4%	$1,400	$7,715	$15,685	$15,685	$107,281
42	83	4%	$1,400	$8,358	$9,080	$9,080	$100,268
43	84	4%	$1,400	$9,024	$1,530	$1,530	$0
Policy terminated due to insufficient funds							

Needless to say, this client was not happy to hear this news, and given his current financial circumstances, he decided to cancel the policy and take the money, while he still had some money left. What also annoyed this client was that the insurance company did not alert him this was happening. They should have alerted him the first year the cost of insurance was greater than the annual premium being paid and the difference being made up by taking from the cash value. But some insurance companies don't do this. Instead they wait for the money to run out, then they advise the client. I have discussed this issue with a few companies but have not seen any changes yet.

Cash Surrender Value and the ACB

So, $40,952 (at a specified date) as a cash refund sounds good, but unfortunately there is another surprise with these old policies. The insurance industry calls this the Adjusted Cost Basis (ACB) — which essentially represents the amount of a policyholder's investment in a life insurance policy, e.g., factors that add or subtract from the ACB are premiums paid, extra deposits, Net Cost of Pure Insurance (NCPI), etc. — and which is calculated using a complex formula. Assuming the policy has an increasing cash value, after about year 17, the ACB starts to become lower than the cash value, which means any difference between the cash surrender value and the ACB is taxable. The next table was provided to this client to highlight the amount he could expect, net after tax, if he surrendered the policy:

CLIENT'S POLICY

Policy No.:	123456789
Issue Date:	January 23, 1985
Coverage Amount:	$100,000.00
Death Benefit as of May 5, 2018:	$140,204.43
Cash Surrender Value (CSV) as of May 5, 2018:	$40,952.34
Annual Premium Being Paid:	$1,400.00
2018 Premium Required:	$2,786.00
Premium Shortfall in 2018:	$1,386.00
Adjusted Cost Basis (ACB) as of May 5, 2018:	$21,122.13
Taxable Cash Value If Surrendered May 5, 2018:	$19,830.21
Marginal Tax Rate:	35%
Tax Payable:	$6,940.57
Net After Tax from Taxable Portion:	$12,889.64
Tax Exempt Cash Value:	$21,122.13
Net After Tax Proceeds from CSV:	$34,011.77

I have four suggestions for what to do you when you inherit an existing UL policy:

First, get a copy of the contract for the policy for the year it was issued, if possible, as features and benefits change over time.

Next, get an in-force illustration for the policy as it is currently configured.

Make sure you understand the rules for making changes that may affect its tax status going forward (e.g., inadvertently cause a G2 policy to fall under G3 rules).

Finally, don't forget to verify that the beneficiary designations are still valid, as I have found several of these older policies don't have an updated beneficiary listed.

For new policies, you need to be realistic in your choice of investments, which in turn affects the rate of return (not an issue with minimum funded UL policies for the most part). Don't fudge the numbers. For example, I was asked to provide a second opinion on an illustration where the chosen illustrated interest rate was 6.5 per cent even thought the investment option chosen only had a 3.7 per cent rate of return over the last 10 years.

Make sure you review surrender charges at the time of sale, and document that you have done so to save yourself or a successor agent a lot of grief.

I suggest reviewing the policy at least annually with the client, especially with overfunded policies, and reviewing the investment options to ensure you are meeting the client's risk tolerance.

You'll need to keep a paper trail of how you came to recommend this solution and the chosen details for future reviews, or when dealing with the family should there be a claim. It's also a good idea to have the client sign and date any documents that specify the details of the plan. That way, should there be a future challenge, you have protected yourself from a liability standpoint.

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