FEATURE:
INSURANCE

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By **Richard M. Smarg**

Conversion of Term Life Insurance

What to do when the music stops

Your client, Peter, is the founder and majority shareholder of a successful family business. Following the enactment of the American Taxpayer Relief Act of 2012 (ATRA), he and his spouse, Norma, finally began their retirement income, gift and estate planning. Among the various components in the plan, a $4 million life insurance policy on Peter's life would be needed for his lifetime in trust. However, the insurance advisor has reported unexpected bad news—they've discovered Peter has adult onset diabetes. For the near future, he's likely to be uninsurable or highly rated. The extra cost would substantially diminish the economics of this important part of the overall strategy.

Then came the good news. Coincidentally, there's been a $5 million term life policy insuring Peter, assigned to a bank years ago to cover a prior business loan. Knowing the annual premiums were scheduled to begin substantially increasing, Peter had planned to let it lapse. Fortunately, the policy has a conversion privilege.

If a term life insurance policy is issued with conversion privileges, it can generally be converted to one or more of the permanent policies offered by the carrier in a face amount not to exceed the original term policy. With the relative ease of term conversion paperwork and subsequent ownership changes applicable to the circumstances, the policy can be transferred (sold or gifted) to accommodate the new estate-planning arrangement.[1]

When the policy has been transferred to the trust, and assuming the carrier offers a satisfactory life insurance product for Peter's lifetime, a permanent policy can be issued. Peter's recently diagnosed diabetes will be disregarded in the conversion. The new premium will be based on the same medical classification as the term policy at its original issue date. This term conversion will save the day.

Historical Perspective

For most of the past century, whole life and yearly renewable term were the two predominant life insurance products offered by U.S. insurance companies. Whole life policies with death benefit coverage through age 100 were most commonly purchased with premiums paid for an insured's entire life. Depending on an insured's age, the policy premiums could be accelerated and paid up with slightly higher premium payments through age 65, higher premiums for a 20-year payment policy or even higher premiums for 10-year payment policies.

Whole life policies were referred to as "permanent" coverage because once issued, and assuming all required premiums were paid, cash values would accumulate and a permanent death benefit would be provided for an insured's lifetime. It was common for the guaranteed cash value (exclusive of dividends) to accumulate and equal the death benefit at age 100. Such policies are said to "endow" at age 100.

With competition and time, some insurance company actuaries designed a wide range of whole life policy derivations with different payment periods and endowment dates. Contractual policy cash values were always guaranteed and fully backed by the general assets of the carrier. In the 1970s, other forms of permanent life insurance policy types and designs were developed, such as universal life and variable life. They have non-guaranteed cash values and death benefits dependent on fluctuating credited interest rates or the variable market performance of the investment sub-accounts selected by the policy owner.

Yearly renewable term (YRT) was the most prevalent

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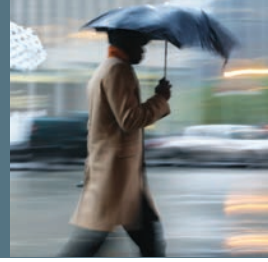

term life insurance product. Term life insurance pays the death benefit (face amount) if the insured dies during the policy term. It has a lower cost because its sole purpose is to provide temporary protection for short durations. YRT generally provides a level death benefit with gradually increasing premiums. The name is synonymous with increasing premiums because the policy owner pays each year's billed premium to renew and extend the policy. The majority of these policies expire at age 65 or 70.

To help mitigate the substantial premium increases at later ages, most carriers eventually offered level premium term policies for a specified number of years (typically, five, 10, 15 or 20) or to a specified age. Some policies are renewable at a new increased premium level (typically, every three, five or 10 years). Depending on the length of the renewal period, the renewal premiums increase through a corresponding actuarially weighted average of costs during the applicable term period. In essence, they reflect and levelize the underlying annually increasing policy and mortality costs borne by the carrier as the insured gets older.

In today's marketplace, 10-, 15- or 20-year level term policies, with level premiums during the specified years, are more common than YRT. Typically, the policy doesn't expire at the end of the guarantee period; it essentially becomes like very expensive YRT. While there's a psychological benefit of paying artificially levelized premiums during the stated term period, these arrangements merely defer and mask the magnitude of sharp rises immediately occurring after the guaranteed premium period—sometimes as much as 25 to 35 times higher. Thereafter, the renewal rates geometrically increase (see "Annual Premiums," p. 54). It becomes cost prohibitive to maintain the policy unless the insured is terminally ill and no insurance alternatives exist. Renewing at such high rates can only be justified if the death benefit is desperately needed. There are no accumulated cash values, so nothing is paid if the insured dies after the expiration of the policy or if it's lapsed due to non-payment of premiums.

Term or Permanent?

While it's true that term insurance will initially cost less than permanent insurance, term policies will either contractually expire before the insured's actuarial life expectancy or they'll become cost prohibitive. For typical estate planning, business succession or life-long family income needs, term insurance isn't likely to be the preferred long-term solution. Alternatively, permanent insurance provides long-term and tax-advantaged benefits. Adequately funded permanent life insurance contracts provide a death benefit for life. And, especially post-ATRA, certain heavily funded policies can avoid the higher income tax on accumulations and help supplement retirement income with tax-free withdrawals and loans.

Term insurance is an ideal solution in situations that call for temporary coverage or income protection, such as young families or new businesses with modest incomes and high insurance needs. For example, term insurance efficiently covers family income earners to pay off mortgages and similarly covers small business owners to ensure that business loans can be paid in the event of a premature death.

Term insurance can be a smart solution for businesses with a short-term need to offset risks and expenses due to the demise of a key person or to cover certain financial obligations of a buy-sell or stock redemption arrangement. For aspiring young professionals, acquiring coverage at an early age is prudent—establishing and locking in medical insurability while one's health is at its best and before the ensuing effects of aging have made it difficult or impossible to secure the most efficient rates. Many carriers offer specific policies that contractually include a conversion option, while others do not.

Additionally, taking advantage of this long-term strategy to lock in medical insurability also applies to the adult children or grandchildren's role in an affluent family's intergenerational estate plan.

Fortuitously secured adequate term insurance at standard or preferred rates later results in particularly favorable opportunities to help deal with life's economic challenges and personal, family and business financial plans and obligations. With the help of legal, tax and insurance specialists, appropriate policy ownership and beneficiary arrangements enable life insurance policies to be transferred, benefits received income tax-free and, if desired, paid outside the taxable estate.

Increased Mortality Charges

Recognizing the many situations in which an individual might have started with term life insurance, what happens if his personal situation changes? Consider the good fortune of a successful career, accumulating substantial assets, a highly profitable business or, for a number of reasons, a meaningful increase in wealth. These might all lead to the consideration of permanent life insurance. But, what if, in the interim, "the music has stopped?" In the children's game of musical chairs,

the game is over for the person without a chair when the music stops. In life, once our health has changed, so does the actuarial "music." The unique and favorable economics and tax efficiencies of life insurance solutions may be diminished or eliminated by increased policy mortality charges.

At that as-yet unknown point, the insurance cost may irrevocably become too rich for a business partner's wallet when considering a buy-sell agreement; the cost of a policy owned inside an irrevocable life insurance trust may exceed the available annual gift exclusions; or the increased cost of insurance (COI) inside a maximum funded policy to help supplement post-retirement income might dramatically reduce the potential for strong internal policy accumulations. These would all be disappointing discoveries, but are common occurrences. While there are a variety of creative, and often complex, planning strategies to help reduce the challenge of higher insurance costs, the proven and most effective bridge to lower cost premiums is often the fortunate opportunity to exercise a term conversion.

Annual Premiums

It becomes cost prohibitive to maintain a policy as an insured gets older

$5 Million Term With 20-Year Level Premiums	
Sample Attained Ages	Annual Premiums
54-73	$17,435
74	524,235
75	578,135
76	638,935
77	709,585
78	791,685
79	883,685
80	986,235
85	1,647,735
90	2,636,535
94	3,531,485

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Terms and Contractual Privileges

Not all term policies have conversion privileges. If included, a conversion option allows the policy owner to convert the term policy to permanent coverage without new underwriting or medical qualification exams. Even if the insured's health has significantly declined, the rating (medical classification) on the newly issued policy will be the same as on the original term policy.

The contractual provisions and terms of conversion vary among carriers and even within each carrier's own term insurance policy portfolio. Likewise, the range of permanent policies available for conversion vary from one company to another, but they'll almost always include opportunities for lifetime coverage.

When purchasing term insurance, your client should consider and confirm the inclusion of a conversion option and compare the policy's specific conversion terms. For example, "Terms of Conversion," p. 55, lists the range of conversion options within term policies offered by five popular carriers.

The conversion period is often restricted to a limited number of years—often less than the guaranteed level premium period—and may not exceed age 70 or 75.

If a waiver of premium rider for disability is included on a term policy, some carriers allow it to be carried over to a converted permanent policy. This allowance is particularly valuable during a qualifying disability, as not only may the insurance company waive the premiums, but also, permanent policies usually accumulate substantial cash values. The carriers differ on their privilege to convert if the insured is already on disability status.

The minimum face amount that can be converted varies by carrier and sometimes among a carrier's different policy series. Generally, the entire term policy face amount can be converted without an upper benefit restriction.

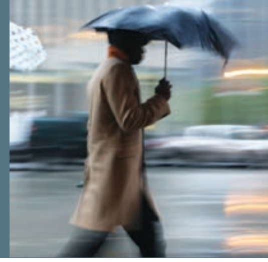
Conversion credits are often provided, although they're sometimes limited to a specific number of years. Usually the equivalent of the prior year's term premium, the credit is applied towards the payment of the first permanent policy premium at the time of conversion. With ownership and all else being equal, the credit isn't taxable.

The full range of permanent policies otherwise offered by the carrier at the time of conversion is generally available for conversion. In recent years, the most common exception involves conversions to no-lapse guarantee products.

Additional Planning Strategies

If the circumstances for using a term conversion present themselves, and the period for conversion hasn't expired, the first consideration is often one of timing. The carrier's method of determining an insured's age (current age versus nearest age), the available opportunity to back-date the policy conversion, the premium pricing differential and death benefit and cash accumulation projections should all be considered.

Although the full amount of the term insurance policy death benefit should be available for conversion, most carriers will also allow partial conversions. This



Terms of Conversion

Options offered by five popular carriers

Company	Conversion Period	Can Waiver of Premium Be Carried Over?	Minimum Face Value	Conversion Credit	Permanent Portfolio Available?
A	For period of level premiums up to 20, but not after age 70	Yes	$50,000	None	All in portfolio except no-lapse guarantee
B	Lesser of 10 years or age 75	Yes	$250,000	Yes	All in portfolio
C	First 10 years, but not after age 75	Yes	$100,000	Yes	All in portfolio
D	For period of level premiums up to 20, but not after age 75	Yes	$250,000	None	All in portfolio except no-lapse guarantee
E	Lesser of 5 years or age 65	Yes	$25,000	Yes, but only during first 5 years	All in portfolio

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lenience provides the opportunity to convert the term policy into two or more permanent policies. This shift can occur in stages over a period of time, perhaps to plan for different periods of coverage, much like a laddered bond portfolio. Phasing into a complete conversion over time might save money by providing certain cash flow relief or by facilitating integrated estate or retirement planning opportunities. While a portion of the term policy has been converted, the remaining balance can be maintained.

Converting to different types of permanent policies might be preferable. It's important to make the extra effort to discover and consider the carrier's full range of potential new permanent products. Converting a portion of the term policy into a series of policies with different designs not only provides diversification, but also the opportunity to address more than one objective.

For example, your client might want to take advantage of the simplicity and relative safety of traditional universal life based on credited interest rates, while simultaneously implementing a variable life policy with a full range of investment sub-accounts. Or, a policy could be efficiently designed to primarily accommodate the need for a long-term death benefit, while another policy could be heavily funded to accumulate as much cash value as possible or help facilitate a long-term care planning strategy. There may be unlimited conversion opportunities to tailor a plan to fit the policyowner's unique objectives and desired results.

Track and Monitor

Due to the probability of changing circumstances, at the time of issue, the policy owner and his advisors should identify the conversion option's terms and plan to track the expiration of its conversion period. For most people, the purchase of life insurance isn't as exciting as buying real estate or investments with high growth potential. Therefore, it's not uncommon for policyowners to place newly acquired policies in a desk drawer and hardly give them a passing thought for years. But, time does pass, and health changes often occur without warning. Taking advantage of term conversion options "after the music has stopped" can only occur if the conversion period hasn't already expired. Not unlike real estate leasing options-to-buy or investment stock options, the valuable planning opportunities associated with a term life insurance conversion option should be monitored. As with so many property and investment contracts, you either use it or lose it.

Endnote

1. While not the subject of this article, any applicable issues associated with Internal Revenue Code Section 2035 (transfers of life insurance within three years of death) should be addressed.