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Survivorship Life Provisions

Financial advisors are often asked to prepare analyses or make recommendations concerning life insurance as an estate conservation tool. In many cases, the client's team of advisors - including a tax attorney, accountant and insurance agent - will recommend the use of a "survivorship life" or "second to die" contract.

Many of these products look very good on the surface and seem well suited to play the role assigned to them. Unfortunately, these policies sometimes prove to be inflexible, sensitive to changes or unable to achieve the projections that have been presented: the kind of surprise people expect to avoid.

How can one spot these potential problems before it is too late? Experienced practitioners may find several primary areas of weakness. By examining these areas, they can help the estate planning team design an insurance program that will deliver what the client expects.

- **The most basic weakness is unrealistic assumptions**

A major life insurance company recently sent a letter to its field associates that admitted the industry's problems in this regard. It stated, in part:

> *We are aware of at least one lawsuit, already filed on survivorship product, where a 90 basis point interest reduction was introduced into the dividend formula within a year of issue, extending a projected eight year vanish to 14 years. The client is now suing, claiming misrepresentation by both the company and the agent.*

- **Fine print in the projections**

Often, so-called paper projections are based on such gimmicks as interest-rate enhancements, bonuses, non-guaranteed termination dividends (sometimes called maturity dividends) or more aggressive pricing assumptions than can realistically be supported in today's volatile interest rate environment. One should question the integrity of a company whose illustrations project interest rates at an unrealistic 10% or 11% level.

Although illustrations based on lower rates are probably available; the fact remains that a company is either deliberately misleading the public or artificially subsidizing the contract. Either way, the client will get a nasty surprise when, inevitably, the company lowers its rates to make up the difference. It is only a matter of how soon and how serious the surprise will be.

- **Variable Universal Life illustrations**

A variable life policy permits the policy owner to select from the investment accounts an allocation of the portion of the premium remaining after payment of the mortality charge, administrative costs and premium taxes. Based on the historical performance of these accounts, one might or might not enjoy a similar future investment performance. Any purchase of Variable Life should be accompanied by illustrations at both historical and conservative rates of return - and if the policy owner is inclined to be somewhat speculative in account selection, he or she should consider the impact of negative account earnings.

- **Policy sensitivity to change**

Some contracts are so sensitive that even the slightest change in interest rates or mortality assumptions can drastically affect policy values. Indeed, one agents' manual warns about the problem in graphic terms:

The pricing assumptions in the current dividend formula are supportable today, but are very aggressive and may change in the future. Several companies have already reduced their dividends or are paying them out of their capital surplus to maintain previous dividend projections. To protect your clients from future product performance problems (and you from their wrath), we suggest that you run every proposal on a one or two percent interest reduction from the current dividend scales.

- **Unwarranted death assumptions**

Many illustrations are based on the very small probability that both husband and wife will die in the same year. Sometimes illustrations use inappropriately long life expectancies, so the premiums shown will be artificially and unrealistically low.

- **Deceptive policy riders**

In addition, some products add term riders to project lowered premiums, making the contract even more sensitive. As the clients grow older, the amount paid for term insurance increases - often dramatically. At the same time, if interest rate projections are not met, the amount of base coverage available to produce dividends to pay these costs will be reduced, a result that will be magnified in later years.

As the term insurance costs go up faster than projected and the dividends fall farther and farther below optimistic projections, an unexpected explosion of costs could occur later in the contract. Purchasers should look for guaranteed provisions in any contract, rather than assumptions based on gimmicks.

- **Lack of policy flexibility and liquidity**

Many of today's survivorship policies are very inflexible. The general appeal of these contracts is based on current tax laws, and any estate plan established on the present allowable gift tax exclusion is based on the same premises.

If tax laws stayed the same forever, then flexibility and liquidity would not be a crucial issue. However, recent history shows that tax law changes are inevitable, which many professionals learned the hard way when Congress changed the rules on the deductibility of interest on policy loans. When they were sold, these policies met clients' needs. When the laws changed, major problems arose.

Of course, client situations can also change. A sound estate planning strategy while a client is employed may be a financial burden if his job is eliminated or some other catastrophic setback occurs.

SURRENDER & SPLIT OPTIONS

Since changes in tax law and client circumstances are very likely, clients should be able to surrender their policies at the end of the second year and recover a reasonable portion of the premium paid. A client also should be able to modify the payment amount or schedule to fit changing situations.

One change in the client's circumstances is worth particular consideration: divorce. Almost all currently available survivorship contracts allow policy splits between divorced spouses. However, the fine print in some contracts can

create big surprises. For example, some policies force the husband and wife to prove evidence of insurability at the time of the split, which is a major disadvantage, particularly with older clients.

In addition, some split-option or exchange riders add significant costs to the contract each year the policy is in force or allow the company to charge a split or exchange penalty that can further erode cash values. It is certainly preferable for the clients to be able to split the entire policy. Contracts that use term riders often exclude them from the split option - something that should be verified before making any decisions.

It is also wise to investigate illustrations of the individual policies that would be issued in the event of the split. Some insurance companies have special "conversion policies" - essentially, new contracts that require the client to pay full commissions to the agent, high mortality charges and other new policy costs the client has already paid. Obviously, a contract with high early cash values and with provisions to allow a split without proving financial or medical insurability is ideal. This type of contract minimizes the client's exposure to loss should circumstances change.

SUITABILITY REVIEW

The estate planning team should take the lead in evaluating survivorship contracts. They should look for high first-year cash values so that the client is protected from surprises. In the review of illustrations presented by different insurance companies, they should carefully examine the interest rate and cost of insurance assumptions used, searching for gimmicks or tricks.

Another red flag is the use of term riders that make the contract sensitive to slight changes in interest rates or mortality charges. What are the effects the first death would have on the premium payment schedule? Is there flexible premium payments so that clients are protected in the event of changes in their circumstances or in tax laws?

Because tax laws and the client's situation may change, the client will need the best planning advice available and a contract that does not offer unpleasant surprises.