EQUITABLE

The PPH Exam

Questions answered for financial professionals

Advanced Markets

A unique approach to policy review

Life insurance policies should be reviewed periodically to make sure they continue to match the current needs of a client. Areas to cover include assessment of the amount and purpose of life insurance coverage, type of product, owner/beneficiary arrangements, how best to fund premiums, performance, impact of the insured's health status on the potential for a rate reduction or product conversion, product selection, insurance carrier ratings and the importance of cash value versus death benefit for a policyowner.

The PPH Exam

Equitable's PPH Exam (Purpose, Product, Health Exam) is a unique approach to policy review that breaks down the key elements of planning with life insurance into three prongs: purpose, product and health. Each prong should be discussed separately since they require specific considerations.

The PPH Exam is a policy review, NOT a replacement program.

Prospects for the PPH Exam are:

Individual policyowners of life insurance who have not recently evaluated their coverage needs and current policy performance.

Businesses or business owners with key person, buy-sell, executive compensation arrangements or creditor insurance.

Trusts owning life insurance that has not been reviewed in the past 3-5 years, and CPAs and attorneys who recommend coverage for their clients.

Charities owning life insurance should periodically assess the performance of life insurance policies and determine whether existing planning needs updating.

The purpose prong

Life situations will change for clients over the course of policy ownership so it is crucial to regularly examine the purpose of a life insurance policy. This review aims to match the client's coverage to his or her current goals. Recent client planning changes may give rise to the need for additional coverage or cause a client to explore new products and riders now available in the market.

Ask the policyowner if he or she needs death benefit protection only or whether flexibility to access cash value is also important. Depending on the purpose of the coverage and accounting for changing economic and tax environments, a discussion of the uses of cash value should take place. Even if the client does not believe anything significant has changed in his or her life, there are still product changes and health changes he or she may not be aware of. It is also important to make sure funding is adequate to maintain the policy.

The PPH Exam may also be used if a client foresees certain changes in his or her economic or planning situation in the near future. It is better to get ahead of any expected changes and be proactive. Discuss the various factors that may affect a client's portfolio and plan ahead for the changing economic landscape. It is possible to seek out and implement the best strategies for growth during favorable, as well as unfavorable, market conditions.

The product prong

This is an opportunity to discuss the moving parts of a life insurance product and highlight opportunities and risks within life insurance products that make them such dynamic and valuable assets. Considerations include:

Risk of lapse
Although many product issues involve risk of lapse, it is possible for policies to perform better than expected, as well. Policies are affected by interest crediting rates, policy charges and funding. Funding of a policy is a key factor in policy performance and is impacted by a client's financial situation and available funds for premium payments. Certain products have flexibility to skip premium, but this is generally not available with secondary guaranteed UL.

Funding
Permanent life insurance policies must be funded at an adequate level to perform as illustrated. Review of an inforce illustration will provide valuable insight on how the policy will perform given certain assumptions. Depending on the review, a policyowner may choose to increase coverage or replace the policy with a less costly one.

Time horizons
Policyowners purchase life insurance for a specific need or with the expectation that the life of the policy would last as long as the insured's life. If an inforce ledger shows the policy life ending prior to either the expected date of the need or the insured's life expectancy, then the planning should be re-examined.

The health prong

There are three things that can happen to an insured's health. It can improve, decline or remain the same. If it improves or declines, clients will want to know so they can make informed decisions. A client may own a term policy with a conversion privilege and not be aware of the opportunity to own permanent coverage. A simple review of health changes can identify eligibility for a reduced rate. Replacing an existing policy will affect the contestability clause, the suicide clause, and the surrender charge period and expenses. All will start over again. This should be considered and measured against the size of the rate reduction and other planning involved. When additional coverage is needed, recall that underwriting guidelines change and what may not have been feasible medically in the past may be accepted today. Check with insurance carriers for their niches.

Getting started: the PPH Exam

1 Gather information from the policyowner in order to conduct the PPH Exam. This will help create a comprehensive profile to better understand your client's goals.

○ **Fact finder about the current situation**

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2 Existing policy(ies) will need to be reviewed to determine if they continue to meet client needs. Secure the authorization form and obtain your client's current life insurance annual statement, an inforce illustration and/or policy. With the information from the annual statement, as well as details on the client's current health, enter the data into a new illustration to determine if there is a potentially meaningful improvement.

○ **Authorization form providing you with access to existing policy information (one form per carrier)**

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3 Identify opportunities and risks through product performance analysis on existing coverage. Visit our website or contact Equitable Advanced Markets for more information on this tool.

○ **Equitable's PPH Exam analysis tool**

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4 Assess health information. Compare current client medical conditions with those existing at the time coverage was purchased.

Business

Equitable has extensive materials to support cases involving Employer-Owned Life Insurance (EOLI) under IRC Section 101(j). They assist in identifying applicable cases that require compliance and how best to manage the process. Although EOLI cases may seem straightforward and simple, they still require proper administration on the part of the employer/policyowner. Check EOLI policies today to make sure the death benefits are maintaining their income tax-free nature.

Trust

A PPH Exam for a trust-owned policy is similar to any other. The key differences include the increased liability that a trustee is exposed to if policies are not reviewed and the need to review coverage needs within the context of applicable trust provisions. Trustees have a fiduciary duty to review life insurance policies and verify they are matched with the trust purpose and performing as expected in accordance with the trust document.

Charities

Many charities own life insurance policies on 1) donors or 2) the lives of their key employees. For existing policies, it is prudent for charities that own life insurance to conduct a periodic review of the performance of life insurance policies that are included in their asset portfolio. As fiduciaries, officers of public charities may be held accountable for the financial impact life insurance policies, as well as other assets, have on the overall investment results of the portfolio of the organization.

Facts and circumstances

The purpose of the life insurance, along with the facts and circumstances surrounding the purchase or gift to the charity, will remain an important element in any policy review. This can include any promises made by the organization or commitments made by the donor upon the purchase or the acceptance of the contribution of the life insurance policy. The charity may have agreed to limit the use or application of the policy values. The donor may have committed to make future premium payments. A change in the donor's economic situation or the charity's mission can require a policy review.

State law

Finally, charities may also face limitations or guidelines that may be imposed by state laws, such as the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has been adopted by most states and includes a prudence standard that directs those responsible to act as a prudent investor would under similar circumstances regarding designated funds and restricted gifts. The duty of loyalty remains mandatory under other applicable laws.

Charities recognizing the value of life insurance in their planning should regularly use the PPH Exam so they can rest assured the coverage will perform as expected and be there to meet important and evolving planning needs.

Policyowner considerations: keeping existing policies

New contestable and suicide periods

New contestable period and suicide period begin when a new policy is purchased. For replacements with the same insurance carrier, some apply a new contestable and suicide period only on an increase in the amount of insurance.

Existing loans

Certain policies that are inforce for a period of time, often 10 years, will have favorable current loan interest rates or loans where current interest crediting rates equal the interest rate charged on the outstanding loans. In some situations, loans are not transferable from one policy to another. Some insurance carriers do not recognize the transfer of a loan as a tax-free exchange, even if the receiving company can accept the loan.

Guaranteed crediting rates

Older policies may have a higher guaranteed minimum interest crediting rate.

New acquisition costs and new surrender periods

New life insurance policies contain sales charges and acquisition costs, as well as new surrender charge periods. Older policies may have already accounted for these charges and may be out of or almost out of the surrender period. Also note that as cost of insurance charges increase at older ages, existing policies may have sufficient policy cash value to compensate for those increasing charges.

Tax law benefits — TAMRA and "cash-rich testing"

Life insurance policies issued before June 21, 1988, may have some tax benefits that are not available with a new policy. Those policies are generally not governed by the Modified Endowment Contracts (MEC) rules, which reduced the amount of money that can be paid into a life insurance policy in the early years without losing the "first in, first out" treatment of withdrawals in life insurance. If a policy is a MEC, any money withdrawn is considered income first, and subject to a 10% penalty if withdrawn prior to attaining age 59½. Certain changes to such older contracts, however, can cause the policy to become subject to the MEC testing. In addition, the life insurance corridor amounts may have been higher on policies issued before June 21, 1988, so there may be higher funding limits than for policies issued after that date.

Many of the "cash-rich testing" rules began as of December 31, 1984. One of these rules is known as the Recapture Ceiling Test and can result in premiums being "forced out" of the policy, sometimes causing taxation of those premiums. A "force-out" usually occurs when there is a reduction in benefits under the contract (face reduction, change of death benefit option from B to A, etc.). Policies issued before December 31, 1984, are generally not subject to this test.

Policyowner considerations: purchasing a new policy

More competitive policies
Like all businesses, insurance carriers strive to find new innovations and lower costs that can lead to a much more competitive product, with lower costs and/or features and benefits not available on earlier policies.

Improved mortality
Improvements in medicine have resulted in an increase in life expectancy. Because of this, many new policies have lower mortality expenses than existing policies, sometimes significantly lower.

More underwriting classifications
Years ago, there were fewer underwriting classifications available. Since carriers continuously improve underwriting classes, your client might benefit from a lower mortality charge in an exchange of an older policy for a newer one. Even if the insured falls into the same class, it's possible the mortality charges on the new policy might be lower than the mortality charges on his or her current policy.

Extended maturity
Many existing policies have an age 85, 90 or 95 maturity date. When a policy matures, the policy cash values will become payable to the owner of the policy, and taxes will be due on any gain. If a policy matures with a loan outstanding, the situation could be worse. One of the real benefits of life insurance is the ability to withdraw cash value up to basis tax-free, then switch to loans. However, if a policy matures with an outstanding loan, any gain received is taxable. Because the loan proceeds have usually been spent when the loan was taken out, paying the income tax on policy gains upon maturity can be devastating. There may not be enough net cash value in the policy to pay the tax.

These problems are avoided with some new policies that have no maturity date. They are designed to continue the death benefit as long as the insured lives. At age 100, most charges are discontinued and any cash value continues to accumulate at the current interest rate. If loans exist, as long as there is a positive cash value and the loans are kept inforce, no tax will be due. At the death of the insured, the net death benefit is paid (face amount minus loans and withdrawals).

Note:
Some insurance carriers may permit a policy with a maturity date to be extended beyond the policy's original maturity date. In addition, policies that endow at an early age may not be able to receive 1035 treatment if exchanged for a policy that matures at a later age. For example, a policy that endows at age 85 cannot be exchanged for a policy that endows at age 100 under IRC section 1035.

Policyowner considerations: purchasing a new policy (cont'd)

Policy loans

Loans on existing policies may have become a challenge. New policies with attractive loan features may be beneficial when considering a new policy. Under the IRS 1035 exchange rules, the IRS allows for the transfer of a loan along with the cash value from an existing life insurance policy to another life insurance policy (subject to policy limits), so long as the insured and owner remain the same. Some insurance policies offer attractive loan interest rates that might not be available on the existing policy. The new policy might have a loan provision where the interest credited on the loan amount is equal to the loan interest amount charged on the loan. This could be important if the policyowner does not plan to repay the loan. The ability to use a cash withdrawal to completely or partially repay the loan is another potential benefit. However, the policyowner may not receive favorable tax treatment on the transfer if the purpose of the transfer is to repay the loan. If the insured wishes to repay the loan via cash withdrawal, he or she may consider repaying the policy loan in a later policy year.

Company strength and stability

One of the most important factors an insured should consider is the strength and stability of the issuing life insurance company. The higher the rating of a company, the better the company is able to keep its promises to its policyowners. All guarantees are based on the claims-paying ability of the insurance company.

Tax law benefits

Previously, we mentioned that if a contract was issued before June 21, 1988, it may have certain tax benefits that are not available with a new policy. If one of these policies is 1035 exchanged to a newer policy, it is possible the new policy will not be a MEC. However, it is important to note that when cash value is transferred from one policy and qualifies under the 1035 exchange provision, it may not be possible to put additional premiums in the new contract without creating a MEC, or the face amount may need to be increased in order to allow for the transfer of the existing cash value. In addition, future premiums may be limited in order for the new policy to conform to the definition of life insurance under Section 7702.

Another example of limitations on the newer policies is with EOLI policies, including some split-dollar and buy-sell situations, where the Pension Protection Act set in place certain rules. Failure to comply with these rules may result in the new policy losing the income tax-free receipt of death benefit proceeds.

For more information, please call the Life Insurance Sales Desk or visit equitable.com.

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