Should I Cancel My Life Insurance Policy?

Exchange Capital Management

August 15th, 2023

Life insurance can provide essential protection during vulnerable times, but there are instances when you might be paying for a policy that no longer suits your needs. There are two main reasons why people consider canceling their life insurance policies: they either no longer need coverage, or the premiums have/will become too expensive. If you find yourself in one of these scenarios, deciding whether to cancel the policy or not will depend on the type of life insurance you have.

Term Life Insurance

Term life insurance is about as straightforward as it gets – you purchase coverage for a specified length of time, typically a handful of years or several decades. Most buy term life insurance when starting a family, ensuring their loved ones can maintain their lifestyle in the event of the insured's death. More often than not, individuals will insure themselves for longer than necessary, aiming to lock in a lower rate and have more flexibility with the policy. This often means you'll have to continuously assess your coverage needs and determine if the insurance should be canceled.

For example, let's say you signed up for a 30-year term policy. However, around 26 years in, you've come to the realization that your children have become financially independent, and you've built up enough savings to cover any potential financial risks in the event of your death.

In this scenario, it’s often recommended to cancel the life insurance. Luckily, this is an easy process with term insurance – you just need to stop paying your premiums and the policy will disappear. This decision might be difficult because you've paid into the policy for 26 years, and it may feel unsatisfying to lose out on the last four years of coverage. In reality, if you no longer need the insurance, it’s often in your best interest to cancel and save money.

Permanent Life Insurance

Many individuals who consider canceling their life insurance will often have a form of permanent insurance – typically whole life – as historically, this option was more popular when they needed coverage.

Most don’t need coverage for their entire life. If you have ample savings and no one is dependent on your income, assets, and support, then it may be time to cancel the policy. However, permanent life insurance is not as easy to cancel, and you shouldn’t stop paying premiums.

Permanent life insurance has a savings component within the policy, called a cash value account. Technically, you own this asset and because of this, you shouldn’t simply discard the policy. If you stop paying premiums, the insurance company may charge the policy via a loan for the money not paid. In many cases, insurance companies don't need to inform you about establishing a loan, and if they do, it may be in the form of a simple letter that is easy to overlook.

On top of this, they often charge high-interest rates on the new loan. As missed premiums are added to the loan and the interest compounds, the balance of the loan quickly outpaces the cash value. At that point, the insurance company will close the policy and take all the money you've saved in the cash value account.

If you're no longer interested in paying premiums but want to steer clear of the company opening a loan on your policy, then you have three options:

> **Use the remaining cash value to pay for the premiums:** If your cash value has grown enough to cover the premiums for the rest of your life, you may be able to ask the insurance company to pull the premiums from the cash value, relieving you from out-of-pocket payments. However, not every policy is the same and some companies may not allow you to do this.
>
> While this isn’t technically canceling the policy, it’s best if you want to avoid taxation and maintain the death benefit. Remember, you must ask the insurance company to do this, not asking will commonly result in them opening a loan for the missed payments.

Purchase reduced paid-up insurance: If you no longer need coverage, or simply need less coverage, you can use the cash value to purchase paid-up insurance. Essentially, you give the insurance company the cash value in exchange for a whole-life policy with a smaller death benefit and no premiums.

For example, let's say you have $50,000 in cash value. You could give the insurance company this money and in return receive a $100,000 death benefit with no additional premiums or expiration date.

Cash-out the policy: If the other two aren't suitable options, you can cash out the entire policy (i.e., cancel the policy). Consider this option carefully as it is a taxable event.

Here's an example: Let's say your total contributions to the cash value is $60,000 and over the policy's lifetime, your balance has grown to $100,000. If you decide to cash the policy out, you will owe income tax on the $40,000 gain.

If you are teetering between tax brackets, adding the earnings to your taxable income could push you into a higher bracket. Therefore, the amount of taxes you owe could significantly reduce the amount of money you receive when cashing out a policy.

Other Considerations

If you're not keen on outright canceling your life insurance, there's another option available called a life settlement. This involves selling your policy to a third-party company. In return, the company will pay you a lump sum, which might be more than what you'd receive by simply canceling your policy, though it will be less than the full death benefit. The exact amount you get depends on factors such as your age, health, policy premium, and death benefit. In most cases, you'll still owe taxes on a portion of the proceeds.

Once the company purchases the policy, they become responsible for future premium payments and will receive the death benefit upon your passing. These companies prefer to buy from older policyholders or those with shorter life expectancies.

Even if you have a term life insurance policy, you may still have the opportunity to sell it if it includes a conversion rider. With this rider, you can convert your term policy into a whole life insurance policy. Once converted, you can then sell it to a company that's interested in taking it over.

The Bottom Line

Canceling a life insurance policy requires careful consideration. In most cases, if you don’t have people relying on your income and support or the premiums are unaffordable, it may be time to explore other options. However, what exactly you should do with the policy will depend on the type of insurance, the cost of premiums, and your tax liability.