SOLVING ISSUES WITH LIFE INSURANCE PLANNING

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YOUR INITIAL REVIEW

Analysis of the Issues

- The economic (interest rates and volatile equity markets) and the tax environment that affects why and how life insurance is purchased, owned, paid for and managed has created uncertainty among policyholders and their advisors about:
  - Whether existing policies are needed or wanted for their original purpose, especially given the doubling of the transfer tax exemptions from 2018 to year end 2025 and then the possibility of rollback in 2026
  - Whether existing policies should be supported and, if so, to what extent
  - How existing policies should be managed economically going forward
  - How existing policies should be supported and managed from a wealth transfer tax perspective going forward
  - How the arrangements under which the policies are financed, as well as the arrangements, themselves, should be managed

Understanding the Situation

- What are the client's objectives, priorities and constraints, including insurability?
- The vintage, type and construct of the policy
  - No, they don't get better with age
- The terms and tax characteristics of the ILIT
  - Do they still make sense in this environment?
- The type and vintage of any split-dollar or other financing arrangement to which the policy is subject
  - Do they still make sense in this environment?

Range of Options

- Depending on the context and many other factors, the outcome of the discussions might be to:
  - Grin and bear an increased premium to keep the policy in force
  - Surrender the policy
  - Manage it to reduce the outlay, stabilize performance, etc.
  - Redeploy it for investment purposes
  - Replace it with another policy or an annuity
  - Sell it in a life settlement
  - Donate it to charity
  - Leave the policy alone, but fix the ILIT by modification or decanting
  - Leave the ILIT alone, but fix the split-dollar or other financing arrangement
  - Fix both
  - Some combination of the foregoing

GATHERING INFORMATION

The As-Sold Illustration

- Based on what the client originally bought
- Shows underwriting classification, policy construct, the then current assumptions, premium and planned duration, pattern of projected cash value and death benefit at ‘relevant’ ages, age policy matures, etc.
- Is there an accelerated death benefit provision to fund long-term care cost?

The Inforce Illustration

- Similar to as-sold illustration, but starts with current year
  - Be sure it includes (when available) a report detailing annual policy charges for costs of insurance and other policy expenses
- Some things to look for:
  - Any changes in policy structure, death benefit option, etc.?
  - How long will the current premium support the death benefit?
    - Is the policy underfunded? Overfunded?
    - When (if ever) will the policy be self-sufficient?
  - Are there any loans against the cash value? If so, is the loan "problematic"?
  - If the policy is EIUL or VUL, what is the index or how is the cash value invested?
- Also get the current policy statement from the carrier
  - By the way, confirm the policy owner and beneficiary!

Other Related Documents

- If the policy is owned by an ILIT get a copy of the trust (and any gift tax returns reflecting gifts to the ILIT).
  – How have the premium gifts been treated and how much gift tax/GST tax exemption does the client/grantor (and his or her spouse) have left?
  – Is the ILIT a grantor trust? If so, how and as to whom?
    - Grantor trust status could be a critical part of "fixing" the problem, e.g., maybe the next premium transfer wants to be a loan.
- Is the policy subject to a split-dollar (or other financing) arrangement? If so:
  – Get a copy of the agreement
  – If the arrangement is an economic benefit arrangement <u>of any vintage</u>, get an in-force illustration that shows the annual economic benefit through policy maturity and if it is based on carrier term costs or Table 2001.

What Else to Consider

- Does the client still need (or want) all of the insurance.
  - If so, to what age?
  - If not, need (or want) a lesser amount? If so, to what age?
- Is it about cash flow or the policy itself?
  - If it's cash flow, let's see what we can do (and what the client is willing to give up).
  - If it's about the policy, is it a matter of basic construct, which can't be fixed (absent an exchange) or a matter of policy management, which can?
- Is it about the carrier, e.g., ratings have dropped, doesn't answer the phone, etc.? Has the carrier changed?
- Is it about the gift/GST tax implications of paying premiums?
- Is it about the arrangement or plan, e.g., a split-dollar arrangement with no end in sight except death?
- Maybe it's about the ILIT (and not the policy)
- Maybe it's about more than one of these

EXPLORING THE OPTIONS

Cash Flow Problems

- Determining the cause of the crunch will help determine a solution
  - The client just doesn't have the cash flow or has too many competing needs for the cash and/or,
  - Dividend or crediting rates dropped, thereby requiring increased premiums to support the death benefit or the same premium to be paid for (way) longer than ever anticipated
- If the policy is whole life
  - Get an illustration that shows a change of dividend option from buying paid-up additions to reducing premium. Client will pay the net premium.
    - Can the client change the option back without evidence of insurability?
  - Be sure client understands the long-term impact of this change
  - If the policy is a whole life/term blend, see if payments for cash building riders can be reduced (and then resumed, if and when).
    - Don't be surprised if the premium cannot be reduced for the foreseeable future!

Cash Flow Problems (cont.)

- If the policy is current assumption universal life (CAUL)
  - See how much the premium can be reduced by the client and still support the death benefit to a targeted age.
  - See whether a change from an increasing death benefit option to a level death benefit option will make a significant difference in the premium.
- If the policy is guaranteed universal life (GUL)
  - Revisit the duration of the no-lapse guarantee. Does client still need to support the death benefit to that age?
  - Ask the agent to illustrate a cutback in the premium followed by a “catch-up” premium in the future that will restore the guarantee
    - Consider getting a letter from the carrier supporting the illustration

Cash Flow Problems (cont.)

- If the policy is variable universal life (VUL)
  - Assume client is still comfortable with VUL as a concept but wants to manage the policy differently (better?) (for the first time?) to reduce some of the volatility in performance.
  - Revisit the asset allocation of the cash value. Then, depending on the policy's features:
    - Reallocate a growth portfolio to either a more balanced fund/portfolio offered by the carrier or constructed by the client.
    - Explore automatic rebalancing feature, if available.
    - Allocate a portion of the cash value to a fixed account from which the carrier will take monthly costs-of-insurance and expenses, rather than taking those charges pro-rata from all of the funds.

Redeployment

- A policy originally purchased for traditional death benefit use can be 'redeployed' as an investment/retirement vehicle
  - Depending upon the type of policy and how it's constructed, it might be an attractive investment vehicle under current tax law.
    - Cash value grows tax-deferred
    - Client can access cash value for income via partial surrenders, withdrawals (up to basis) or loans (even in excess of basis) on a tax-free basis, assuming it is not a MEC
  - Ask the agent to show how the policy can be used for retirement savings/income
    - But this involves more than just picking an age and showing a series of partial surrenders/withdrawals and then loans.
    - Might involve, for instance, an increase in the premium, decrease in the death benefit and a carefully calibrated approach to tapping the policy for income.
  - If the policy is owned by an ILIT, consider how (and at what tax cost) it can be owned by the insured.
    - Use of a swap power in the ILIT; if none, will the trustee agree to sell it (within the trustee's fiduciary duties to the beneficiaries), and, in either case, at what value? And tax consequences?

Exploring the Redeployment

- If the policy is whole life, there will be little flexibility with regard to the premium or other aspects of policy design.
  - Redeployment will be more a function of the client's thinking about the policy than actually tinkering with it.
  - Exchange?
- If the policy is a whole life/term blend, the client might be able to increase the premium (to build more cash value) without evidence of insurability.
- If the policy is GUL, the client can likely increase the premium (now viewed as an investment contribution) without such evidence.
  - However, depending on its vintage, the policy may not generate robust cash values on a current assumption basis.
  - Exchange?

Exploring the Redeployment (cont.)

- If the policy is CAUL or VUL, then more fundamental design changes could be feasible. For example:
  - Consider some combination of increasing the premium for a certain number of years and, within carrier and tax guidelines, reduce the death benefit to reduce the “drag” of the costs-of-insurance on cash value accumulation.
    - Of course, also determine any requirements for underwriting, imposition of surrender charges, possible FOG tax consequences of a death benefit reduction, etc.
  - Illustrate the maximum tax-free cash flow that the policy can generate at retirement by loan and/or withdrawal, tax-free
    - For a given number of years, without requiring more premium to support the death benefit well beyond client’s life expectancy
    - And be sure the illustrations show how any loan and loan interest works!

Surrender

- Ask the carrier for a "surrender quote"
- Cash surrender value in excess of investment in the contract (generally, premiums paid less non-taxable distributions) is ordinary income, not capital gain.
- If the policy is a modified endowment contract, there is also a 10% penalty tax on the amount of income realized, if the "taxpayer" (not necessarily the "insured") is under 59½.
  - Especially difficult if the owner ("taxpayer") is an ILIT
- If there is an outstanding policy loan at time of surrender, then the policyholder will be taxed on the excess of the gross cash value (which includes the loan amount) over the investment in the contract.
  - Which can mean a little cash but a lot of income!

Exchange

- Assume client still wants the insurance but is unhappy with, for instance, the carrier, the type of policy or the required (and immutable) outlay.
- The client wants to explore an exchange.
  - One rationale for an exchange is that the client wants coverage for potential long-term care costs but doesn't want to take the "gamble" of buying an individual policy that he or she may never need.
- First, some caveats:
  - Presume that the existing policy should be retained, i.e., proposed replacement must show that it can legitimately meet the needs more effectively than the existing policy.
  - Never cancel a policy until its replacement is in force!
  - Be sure to identify and address any ancillary implications of an exchange, e.g., exchange as a possible material modification of a pre-final regulations collateral assignment split-dollar plan, etc.
  - Client must be insurable to do an exchange

Applicable Tax Law

- If the transaction qualifies under Section 1035, no gain or loss is recognized in an exchange of one life insurance contract for another on the same insured or for an annuity so long as there is no “boot” received in the exchange.
  - Different insurance carriers and types of policies can be involved in the exchange.
- In order to qualify under Section 1035, the policy received in the exchange must be on the same insured or insureds.
  - Basis in the old policy is carried over to the new policy.
    - Therefore, an exchange under Section 1035 may be helpful to preserve basis even if there is no gain in the policy.
  - Be careful! If there is a loan on the current policy that is extinguished in the exchange, that is “boot” and will taxed as ordinary income (without generating any cash).
    - If the loan is carried over to the new policy, there is no boot.

Internal vs. External Exchanges

- Internal exchange involves same carrier
- External exchange involves new carrier
- Always start with the existing carrier, which might have an internal exchange program.
  - Even if the carrier is the same, check the illustration to be sure it is coded for an internal exchange.
- Potential benefits of internal exchange
  - Less rigorous underwriting
  - Surrender charge on old policy might be waived
  - Commission on new product reduced or eliminated
  - The sales loads and premium tax may be reduced or eliminated

Making Decisions

- When all of the illustrations and supporting material about the products and carriers have been received:
  - Does an exchange make sense?
  - It depends…
    - Does everyone really understand all of the working parts of the policies?
    - Have the usual "what ifs" been covered?
    - All premiums, cash values and death benefits considered, do they clearly understand what they might be gaining vs. losing?

Exchange for an Annuity

- The tax aspects
  - Exchange can be tax-free under Section 1035, assuming again no "boot".
  - Basis in policy carries over to annuity.
- Exchange for an immediate annuity
  - To guarantee a lifetime income
  - But compare to a systematic approach to taking income from the policy
- Exchange for a deferred annuity
  - Maintains the tax deferral, but does client really understand the key tax differences between cash value life insurance and a deferred annuity?
    - To the owner during lifetime
    - To the beneficiary

Sale of Policy

- A life settlement is the sale of a life insurance policy which is past the contestability period issued on the life of a person (who does not have a condition that is likely to result in death within 24 months), for an amount that is less than the policy's face value but more than the cash surrender value.
  - Generally, for older insureds who have had a decline in health
- Based on various criteria for the client/insured, the policy and other factors, the agent can advise:
  - How the marketability of the policy is determined
  - The steps involved in (and after) a life settlement
- Meanwhile, client should see all bids for the policy, the compensation that the agent (and others) will receive, etc.

Some Inside Baseball

- The best policy for a sale is one in which the premium should not be more than 5% of the death benefit and cash value not more than 15-20% of the death benefit
  - The less cash value vis a vis the death benefit, the better
- Insured should be at least 65-70, life expectancy of up to 12-14 years, smoker is better than non-smoker
- Policy issued on a more favorable underwriting basis than warranted and insured's health has since turned for the worse
  - The worse the better (for the sale, not necessarily for the insured)
- Offer will be based on health information provided and the results of a life expectancy study obtained by the purchaser

Taxation of Life Settlements

- Rev. Rul. 2009-13
  - Section 72(e), which applies in context of a surrender, does not apply in the context of a sale of a policy – here it is income tax basis.
  - It held that gain above basis is ordinary income to the extent of the amount of 'inside build-up' that would have been ordinary income upon surrender and capital gain thereafter.
    - Based on the "substitution of income" theory.
  - Ruling also held that life insurance policies are capital assets, but that policyholder must reduce basis by the cost of insurance charges.
    - That portion of the ruling was revoked retroactively by the Tax Cuts and Jobs Act of 2017
    - The Jobs Act also made clear that no exception to the transfer for value rule would be available to the purchaser

Does the Life Settlement Make Sense?

- It depends…
- If there's a settlement offer on the table, it means that somebody doesn't think the insured will live too long.
  - Will the sale and reinvestment of the after-tax proceeds of sale leave a larger amount of money to the survivors than if the insured had kept (and, if necessary, supported) the policy?
  - Ask the agent to determine the lowest premium outlay projected to support the death benefit to just beyond life expectancy. Then compare on an annual basis, the "premium-cost-adjusted" death benefit from the policy to the after-tax result of investing the (after-tax) proceeds of the life settlement to see the "crossover" year.
  - And then ask the insured again, "What if you were to die shortly after the sale (some settlements provide a portion of the death benefit to the family), are you going to be comfortable with an institution owning your policy, do you understand that this will affect your future insurability, etc.?"

Donate

- Can be a low cost means of making a potentially significant gift to charity.
- But will the charity accept the gift?
  - Need to check the charity's policy (no pun intended) on acceptance of policies – they vary widely (from no policy on acceptance at all to detailed requirements for the policy and a plan to pay future premiums)
- Might find that the charity is generally willing to accept policies that meet certain criteria regarding:
  - Age or life expectancy of the insured(s)
  - Amount and number of remaining premiums
  - Type of policy
  - Ratings of the insurer
  - Plan by the insured to pay future premiums; charities will generally not use their funds to pay premiums
    - The issue is donor fatigue
- Will this insured/policy meet the criteria of this charity?

Basic Tax Implications of the Gift

- The donor may be entitled to a current income tax deduction for the gift.
- The transfer must include all of the donor's incidents of ownership in the policy, to comply with the partial interest rule.
  - Which, if it applied, would deny any deduction
- But the amount of the deduction is not necessarily clear

Determining the Amount of the Deduction

- Section 170(e)(1)(A)
  - If a life insurance policy is “ordinary income property”, then the donor would only be entitled to an immediate income tax deduction equal to the lesser of the insured's income tax basis in the policy or the fair market value of the policy (however determined).
  - But query as to the impact of Rev. Rul. 2009-13 on the character of a life policy – it is a capital asset with some aspect of ordinary income; the deduction should be FMV minus the ordinary income portion (gain above basis up to cash value).
  - And the impact of the life settlement market
  - In any event, donor must observe applicable reporting requirements, that is, filing Form 8283, obtaining and paying for formal qualified appraisal from a qualified appraiser (both terms of art) if the value exceeds $5,000, etc., to get the deduction.
    - How do we know if it is or isn’t without the appraisal?

DEALING WITH EXISTING ILITs

Transfer Tax Situation

- Transfer taxes remain at 40%
- Step up in basis at death is in place
- Current high exemptions exist through year end 2025 (currently $12,920,000 in 2023) doubled for married couples, less prior use
  - Unless changed by future legislation (Set to roll back 2026)
  - Use excess of exemption over rolled back exemption prior to year end 2025 or excess will be lost.

What if the Real Problem is the ILIT?

- Many clients established ILITs when the estate tax exemption was a fraction of what it is today.
- Now, with a $12,920,000 per person exemption ($13,610,000 in 2024), doubled for married couples, less prior use (indexed and, barring future legislative changes, in effect through year end 2025) many who have ILITs regard them as albatrosses around the necks of their financial and tax lives.
  - Of course, if the ILITs could talk, many would say the same thing about the products they own!
- Consider "undoing" the ILIT
  - Remembering it is an otherwise irrevocable trust

Options for Fixing a Broken ILIT

- Termination or amendment by a trust protector (if the trust provides for one with this power)
- Court reformation/non-judicial modification (if permitted under local law)
- Decanting (if permitted under local law)
- Distribute the policy to adult beneficiaries (if possible under the trust)
  - Raises fiduciary duty issues for the trustee
- Distribute the policy to a new ILIT (if possible under the trust)
  - Raises fiduciary duty issues for the trustee, unless the new trust has identical dispositive provisions
- Sell the policy to a new ILIT (if a grantor trust), based on FMV
  - Raises fiduciary duty issues for the trustee, with a similar exception
- Sell the policy to the grantor, based on FMV
  - Raises fiduciary duty issues for the trustee
- Have the settlor enter into a swap for the policy (if possible under the trust), based on FMV
- Forget the above and go back the product and cash flow issues

Conclusion

- How having a working knowledge of life insurance can bring value to your clients