FEATURE:
INSURANCE

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Are Your Senior Client's Estate Liquidity Plans About to be Trumped?

Key factors to consider when purchasing and evaluating life insurance

With the election of Donald Trump as President and both houses of Congress currently controlled by Republicans, the repeal of the federal estate tax has become a very real possibility. In fact, on Sept. 27, 2017 the Treasury Department released a framework for tax reform, which specifically proposes repealing "the death tax and the generation-skipping transfer tax."

Estate tax repeal, if it happens, would continue to impact the dynamics of estate planning for senior clients, which has already seen substantial changes in recent years due to a substantial increase in the federal estate tax exemption and the enactment of portability.[1] Wealthy senior individuals and couples who are currently considering purchasing life insurance to provide liquidity to pay estate taxes and paying significant life insurance premiums face an uncertain estate tax future and will need to evaluate whether the purchase makes sense. More importantly, if estate tax repeal occurs, senior clients who've already purchased life insurance to provide estate tax liquidity may have their existing estate liquidity plans "Trumped" and will need to assess what to do with their life insurance policies. Decisions about currently held life insurance and the purchase of new life insurance will both be impacted by increasing life expectancy and product type.

Do you have all the information you need to properly advise your clients regarding their estate-planning life insurance needs? We'll discuss: (1) some key factors for clients who are considering the purchase of new life insurance, and (2) how to evaluate existing life insurance already owned by clients. There's a good chance many policy owners will seek to surrender existing policies if the coverage is no longer needed, and they may be unaware of any potential fair market value (FMV) that could be available to them.

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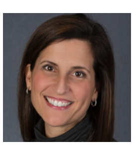

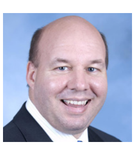

Potential for Repeal Scenarios

Any determination regarding whether to move forward with the purchase of new life insurance or how to handle existing coverage greatly depends on what happens with federal estate tax repeal. It's almost a certainty that a provision to repeal the federal estate tax will be included in the initial tax reform proposal considered by Congress. However, the ultimate outcome regarding estate tax repeal is uncertain. There are three possibilities:

Not likely: Federal estate tax repeal will be permanent. Permanent repeal of the federal estate tax seems very unlikely to happen because it would require the tax reform bill to receive 60 votes in the Senate to avoid being filibustered. This means that a minimum of eight Democrats would need to vote for the legislation. Given that there's been very little cooperation between the Republicans and Democrats in Congress thus far, and especially considering that the nuclear option was used to confirm U.S. Supreme Court Justice Neil Gorsuch,[2] the chances of there being Democratic support for tax reform legislation that would include a provision to permanently repeal the federal estate tax is virtually nil.

More likely: Federal estate tax repeal won't happen. There's a decent chance that an estate tax repeal provision could be compromised out of the tax reform legislation at some point to preserve higher priority tax cuts, such as business or individual income tax cuts. The federal estate tax isn't a huge revenue raiser for the federal

government, considering that very few estates owe estate tax because the individual exemption is $5.49 million (in 2017). However, it's estimated that the cost of repealing the estate tax over the next decade would be a not so insignificant $269 billion, which is slightly less than 1 percent of the federal revenue over that time period.[3]

Some lawmakers may feel that money could be better spent to enable other tax cuts, rather than cutting taxes for a few wealthy estates. This is especially true considering that some in Congress feel that the estate tax was already sufficiently dealt with previously, when the exemption was increased to $5 million in 2011 and indexed annually for inflation. With a long list of tax reform and tax cut initiatives to accomplish, and difficulty in finding ways to pay for all of them, estate tax repeal may not be a high enough priority to make the final cut.

Possible: Federal estate tax will be temporarily repealed. If the federal estate tax is repealed as part of a broader tax reform bill, it may be accomplished using the same budget reconciliation process that was used to try and pass health care reform. Reconciliation bills only require a simple majority to pass in the Senate and avoid the legislation potentially being filibustered. Given that the Republicans currently have 52 out of the 100 seats in the Senate, the best chance of them getting their tax reform agenda passed, including repealing the "death tax," is to use the reconciliation process.

The trade off with a reconciliation bill, however, is that the legislation won't be permanent and must generally sunset within a few years. This is due to the impact of the Byrd Rule, which allows legislation to be blocked if it would significantly increase the federal deficit for a fiscal year beyond those covered by the reconciliation measure, which has traditionally been 10 years.

For the purposes of this article we'll assume that: (1) estate tax repeal isn't compromised out and remains in the final tax reform bill that's passed, and (2) if the budget window for the tax reform bill is 10 years, then the repeal of the federal estate tax will only be temporary and will sunset at the end of 10 years. At this point, it's at best an educated guess.

Time Horizon Planning

The fundamental inquiry when determining how to handle life insurance in light of a temporary estate tax repeal is to ascertain a client's likelihood of surviving the temporary repeal. How should you determine your client's life expectancy? There are multiple sources to choose from that have life expectancy calculators or standard mortality tables, such as the Society of Actuaries 2014 VBT tables and tables put out by Social Security or annuity companies. More reliable sources of client-specific life expectancy calculation use client medical records and questionnaires to produce an individualized life expectancy analysis. Internet calculators are unreliable and can only act as a screening device. Different sources to determine life expectancy can vary as much as 15 years depending on the methodology they use. If your plans revolve around life expectancy, then a 10+ year miscalculation could be disastrous. Methods are continually improving and providing greater accuracy, and the future will most likely include some form of DNA testing. Currently, medical underwriting and longevity analysis performed by institutional life settlement investors comes closest to pinpointing an accurate individual time horizon. However, at this time, no mortal man knows when death will occur. At best, it's still a guesstimate. Let's examine this in more detail.

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There's a critical fork in the road where life expectancy estimates take a different direction based on the underwriting methodology used. Which direction is best for your client depends on your planning objectives. One path focuses on mortality risk and the other focuses on longevity risk. Mortality risk is the risk of dying too soon and has traditionally been the underwriting focus of the life insurance industry. This style of underwriting focuses on health and lifestyle debits. Debits are conditions such as heart disease, obesity, smoking status,

kidney disease, cancer, dementia, diabetes and neurological disease. Mortality risk debits are also given for risk taking lifestyles or high risk hobbies. Such debits can include sky diving, scuba diving, car or motorcycle racing and mountain climbing. High risk professions can also incur mortality debits, for example, professions such as logger, pilot, commercial fisherman, roofer, miner, electric powerline worker and more. On the plus side, many insurance carriers are now beginning to reflect healthy lifestyle habits that allow potential insureds to get a better rate for demonstrating health habits.

> Wealthy seniors who have better access to high quality medical care, greater access to healthy food and lifestyle choice are quite likely to outlive mortality-based estimates of life expectancy by several years.

The other direction you can choose at that fork in the road focuses on longevity risk, the risk of an insured living longer than expected. Keep in mind that for the purposes of this article, the emphasis is on securing accurate life expectancy analysis on senior clients who either currently have life insurance that may no longer be needed or are trying to determine the advisability of new insurance. This method not only examines debits but also focuses on health and lifestyle credits. These credits can outweigh or even cancel out some standard debits. At first glance, some of these credits may surprise you, but if you think about it, they make sense. For example:

- Not currently taking any prescription medications
- Active lifestyle
- Owning more than one home (example: vacation home in Florida, lives in New York)
- Exercising regularly—no matter the age or type of exercise
- Traveling domestically or internationally and the frequency of travel
- Family history of longevity
- Working—full or part time
- Highly functioning (example: may not be working, but volunteers and completes physically and mentally stimulating activities)
- Living without assistance as a couple or alone
- Only seeing physicians annually or as needed
- Only having a primary care physician for health care
- Driving daily or weekly—still having a driver's license without physician's note stating the insured isn't driving

Other factors such as income level can also affect longevity. The life settlement market frequently uses the term "the wealth factor" for the impact of wealth on life expectancy and the fact that wealthy people outlive individuals who don't have the financial means to make lifestyle choices or access medical specialists that result in a longer lifespan. According to the Brookings Institute, males born in 1940 who are at the top 10 percent of mid-career earners can expect to have an average life expectancy of 12 years longer than their counterparts at lower income level.[4] This is notable because most clients using life insurance for estate liquidity reasons are seniors who are or were at these higher income levels. Wealthy seniors who have better access to high quality medical care, greater access to healthy food and lifestyle choice are quite likely to outlive mortality-based estimates of life expectancy by several years.

The bottom line is to make sure that any life expectancy/longevity analysis you secure for your client is specific to your client and takes into account his health and life style credits and income level.

Estate Tax Liquidity

Several options are available for senior clients with larger estates who are considering purchasing life insurance to provide estate tax liquidity, who've determined that they have a good chance of outliving the temporary estate tax period but are still concerned that they may be needlessly paying high premiums should they die prior to the estate tax repeal sun setting.

One is to postpone purchasing the life insurance until the estate tax repeal sunsets. The problem with

this approach is that it may be 10 years or more until the future of the estate tax is known. The client will be 10 years older, and a lot can happen from a health perspective over the course of that time. Thus, the client maybe unable to acquire the coverage in the future when it's needed, or the coverage may be considerably more expensive at that time due to age and health changes. And, even when the temporary estate tax repeal sunsets, there's no guarantee that the outlook for the estate tax will be any more certain then it is now.

A potentially better option that eliminates the risk of a health change and helps ensure that the estate tax liquidity can be obtained cost efficiently, is to proceed with the life insurance purchase now and employ one of the following strategies that provides the client flexibility to adapt as necessary:

1. Purchase convertible term or minimum funded cash value life insurance coverage. If a client is concerned about the possibility of dying during the temporary estate tax repeal period and having needlessly paid large premiums for coverage that's no longer needed, the client could choose to buy 10-year level term insurance (assuming the client isn't too old to qualify for such coverage). Ten-year level term insurance would provide a low-cost solution for purchasing life insurance now but give the client several options should he determine in 10 years that life insurance is still needed to provide liquidity to pay estate taxes:

- If the insured is in good health and willing to go through the full underwriting process, it may be possible to simply replace the term coverage with cash value coverage with a relatively affordable annual premium.
- If the insured isn't in good health, he could choose to continue the existing term coverage. The low guaranteed level term rates will end, but the insured should be able to continue the coverage at much higher annually increasing premiums.
- If the insured isn't in good health and can't readily obtain affordable new cash value coverage, see if the current term policy can be converted into a cash value policy. This needs to be done before the level term period of the policy expires and, in the case of some life insurance carriers, may need to be elected well before the level term period ends. A downside of converting existing level term coverage is that the cash value products that the insured can convert to generally aren't very competitive.

As an alternative to purchasing a 10-year level term product and converting it, a client could instead choose to purchase a cash value product and imitate a 10-year level term product by paying a minimum premium just sufficient to keep the policy in force through 10 years. At the end of 10 years, if the client decides to maintain the coverage, the client can substantially increase the premiums being paid into the policy. The downside is that the premiums in the future needed to keep the policy in force until death might be significantly higher than if the client had just initially decided to pay a level premium for life. The upside is that the client won't have to worry about a change in health preventing him from qualifying for a new policy or about converting into a potentially uncompetitive term conversation product. This also makes the policy more attractive to institutional investors in the life settlement market if your client decides to sell the policy at a later date.

> A flexible ILIT is just a version of a spousal access trust, so it can only be used by married couples.

2. Purchase cash value life insurance using a flexible planning strategy.

What if your client could lock in his insurability and purchase the needed life insurance to provide estate tax liquidity, avoid having the proceeds be includible as part of his taxable estate and have the ability to potentially unwind his liquidity planning if it's later determined it isn't needed and get his money back? Too good to be true? It may be possible to accomplish all this in the right circumstances as long as sufficient flexibility is incorporated into the planning. For this to happen, two things are required: (1) the product used must provide enough flexibility that the client could surrender it after 10 years and get most, if not all, of his premiums back. One type

of policy that may not provide much flexibility would be a guaranteed universal life policy because the cash surrender value after Year 10 may not be anywhere close to the cumulative premiums paid; and (2) the strategy for handling the policy ownership must provide sufficient flexibility to enable it to be unwound, while at the same time ensuring that the death benefit proceeds of the life insurance won't be included in the insured's estate should the insured die while there's a federal estate tax in effect. Two possible flexible planning strategies are:

- a flexible irrevocable life insurance trust (ILIT), or
- having the coverage owned by a family business as part of an entity redemption plan.

> At least two circuits have ruled that life insurance proceeds paid to a business don't increase the value of the business to the extent that they're offset by an obligation to pay those proceeds to an owner's estate pursuant to an entity redemption arrangement.

Flexible ILIT. A flexible ILIT is just a version of a spousal access trust, so it can only be used by married couples. One spouse is the grantor of the trust, and the other spouse is a beneficiary. It can be used with either a single life policy insuring either spouse or a second-to-die policy insuring both spouses. The key to a flexible ILIT is to use an "independent trustee"[5] and to give that trustee broad discretion to make distributions to the spousal beneficiary for any reason and to the exclusion of any other beneficiaries of the trust.

In the event that the estate tax is permanently repealed or the client's estate is no longer large enough to be subject to the federal estate tax, the independent trustee could potentially exercise his absolute discretion to make distributions from the trust to the spousal beneficiary. If the independent trustee were to distribute all of the trust assets to the spousal beneficiary, this would effectively unwind the ILIT.

Estate liquidity planning using an entity redemption. As an alternative to having the life insurance owned outside the estate by an irrevocable trust, it might be feasible to simply have it owned by the client's family business. If the insured owns the business, then the insured has increased flexibility, because the insured indirectly has control over the business owned policy. How is it possible to avoid inclusion of the life insurance in the client's taxable estate if the client is the owner of the business? First, Internal Revenue Code Section 2042, which is the primary IRC section dealing with estate tax inclusion of life insurance proceeds, is inapplicable. It only applies if: (1) the insured possesses incidents of ownership in the policy or, (2) the proceeds are payable to the insured's estate.

In this situation, the insured doesn't possess any incidents of ownership (because the policy is owned by the business) and the beneficiary of the policy is the business rather than the insured's estate. The fact that the business is wholly owned or controlled by the insured also doesn't cause estate tax inclusion, because there's case law and IRS guidance indicating that attribution of a business' incidents of ownership only occurs if the life insurance proceeds are NOT payable to or for the benefit of the business.[6] Therefore, there's no direct inclusion of the life insurance proceeds in the insured's estate if the business is the owner and beneficiary of the life insurance policy. But, what about indirect inclusion?

What's clearly includible in the insured's estate is his pro rata share of the value of the business, which may or may not reflect the value of the life insurance proceeds received by the business. This is where the entity redemption comes in to prevent indirect inclusion. Both the U.S. Court of Appeals for the Ninth and Eleventh Circuits have ruled that life insurance proceeds paid to a business don't increase the value of the business to the extent that they're offset by an obligation to pay those proceeds to an owner's estate pursuant to an entity redemption arrangement.[7]

Valuation of Assets

Most policy owners don't think of their life insurance

policies as an asset they own, similar to other pieces of property that they own and appraise on a regular basis. If a client feels repeal will happen and, based on his estate needs and personalized longevity, doesn't need the life insurance, he immediately thinks the option is to exit it for its surrender value determined by the insurance carrier. However, there might be another value that's a more attractive and better option than surrender: the sale of the life insurance policy in the life settlement market. There's also the possibility that by quantifying the FMV of the life insurance policy, the policy owner will realize that it's an asset worth maintaining and is valuable to his beneficiaries.

Most senior clients are unaware that their life insurance is an asset and that the policy owner has the right to sell it for FMV. It's been a common practice for wealthy clients to assign ownership of their life insurance policy to their beneficiaries or charity without making the connection that this is allowed by the fact that life insurance is an asset, and they can do anything they want with it, including selling the policy on the secondary market for life insurance for its FMV. This was all made possible by a landmark 1911 U.S. Supreme Court decision of *Grigsby v. Russell.*[8] In his opinion, Justice Oliver Wendell Holmes, Jr. wrote, "life insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give life policies the ordinary characteristics of property."[9] Fastforward to 2017, and you have institutional investors such as Warren Buffett, Blackstone Group, Apollo Global Management, BlackRock, hedge funds, pension funds, family offices and banks that prefer investing in this non-correlated asset with good returns and safety of principal. Policy owners have the ability based on the existence of a highly regulated market place to understand the FMV of their life insurance policies and make the decision if available to maintain the contract or exit the asset for its FMV.

One might say that if it's a good investment for institutional investors, then it's a good investment for my client. The answer is both true and false at the same time. Let's examine this life insurance asset value more closely. We've already talked at length about longevity risk. Ask this question: Who's in a better position in regard to taking longevity risk? Is it your client who owns one policy or an institutional investor who owns a large diversified portfolio of polices and benefits from the law of large numbers? We all know the answer. If your client lives past anticipated life expectancy, it can create significant financial cost to keep that one policy going and negatively impact the entire plan.

Let's assume the policy in question is either a term insurance policy or a universal life (UL) insurance policy. The term policy has no surrender value and the UL insurance policy has minimal cash value because premiums were insufficient to produce significant value due to the sustained low interest rate environment experienced over the past decade by the insurance carrier. Your client no longer needs the existing life insurance for estate liquidity and is considering surrendering the policy. This is where a life settlement could factor into the planning process if all the conditions are right. Many are surprised to learn that term insurance policies can be sold for FMV under the right conditions. What are the right conditions? For the insured with this term or UL policy, it all starts with an insured who's 60 or older and has had a significant change in health since the original issue of the policy or any insured over age 80. This senior age group has a good probability of having enough health arbitrage when you compare current health factors to health assumptions that were made at issue date. This health arbitrage creates secondary market value (SMV) most often referred to FMV when valuing other assets such as art and real estate. Because most insureds aren't aware of life insurance FMV, we'll refer in this article to SMV to help emphasize the "secondary market value" of life insurance that most seniors aren't aware of.

If the original purpose for the life insurance no longer exists and the final planning decision is to sell the policy in the life settlement market, a side benefit of the SMV is that you'll already have a strong indication of what it's really worth.

So, now you know what basic parameters from an age and health status help create SMV. What else do you need to know to help your client decide to surrender his policy, retain it for purposes other than estate liquidity or sell it for SMV?

Market-Based Valuation Methodology

Many of your clients may decide to surrender their existing life insurance if estate taxes are eliminated, even if it's only for a 10-year period. They might do this to reallocate their premium payments to other elements in their plan and use what cash is left in the policy for planning purposes before it's depleted by cost of insurance charges. That sounds like it makes sense if they don't want to retain their coverage for other purposes. What about SMV? Would a willing institutional buyer be interested in paying your clients more than the surrender value? What if your client could get several multiples of the surrender value?

This process is called a "life settlement" and is defined as the sale of a life insurance policy to a third party (institutional investor) for a value in excess of the policy's cash surrender value, but less than its face value, or death benefit. A policy owner receives a cash payment, while the purchaser of the policy becomes the new owner and assumes all future premium payments and receives the death benefit on the death of the insured.

As you might expect, these institutional investors have a fiduciary responsibility to get the highest internal rate of return for their fund. Because a fiduciary can't serve two masters, you need to be sure to secure independent representation for your client to make sure that his best interests are being served in the negotiation. As mentioned earlier, there are multiple institutional investors interested in purchasing viable policies but they won't offer top dollar if they aren't forced into competition. This is where a life settlement broker comes in. An experienced broker will create a competitive bidding environment to get the best results for your client.

So, let's back up for a minute and examine the decisions your client has to make about existing life insurance policies put in place for estate liquidity if the estate tax is eliminated. If it's not needed for its original purpose, then is there any other reason to keep or assign the policy? Your client will need to know all of the policy values and look beyond just the values provided by the insurance carrier. Those values are important to know, but what about SMV? It's estimated that 20 percent of seniors who surrender policies are potentially leaving six to seven figures of additional SMV on the table. It only makes sense to get an appropriate valuation of SMV prior to making any decisions about the disposition of your senior clients' life insurance.

In a November 2016 *Trusts & Estates* article, Jon B. Mendelson, CEO and founder of the Ashar Group in Orlando, Fla., discussed how market-based methodology for determining SMV is a true reflection of the "willing buyer/willing seller" definition of FMV.[10] SMV methodology differs from standard appraisal methods and health agnostic insurance carrier estimates of FMV in several critical areas:

- It's based on a full set of objective transactional data and comps from current institutional buyers that represent a true willing buyer/willing seller environment.
- It provides a longevity data point useful for tax planning and hold/pay/change/sell decisions for senior clients.
- It includes an in-depth analysis of the current health conditions of the insured to determine life expectancy. Medical records for the past five years are examined, and a series of debits and credits are applied. Independent third-party life expectancy reports are obtained to provide further definition to mortality assumptions.

The appropriate discount rate is derived from cash flow analysis of current life settlement market transactions (not historical transactions) for real-time comparable data.

This valuation methodology results in a valuable time-stamped, mark-to-market appraisal to help you make complicated planning decisions regarding your client's life insurance. If the original purpose for the life insurance no longer exists and the final planning decision is to sell the policy in the life settlement market, a side benefit of the SMV is that you'll already have a strong indication of what it's really worth.

Unchartered Water

The concept of life insurance as an asset with potential FMV is unchartered water for many fiduciaries and planners. With a potential flood of unneeded policies surfacing from repeal of the death tax, knowing the

SMV of policies on senior insureds could be a game changer for the policy owner. Examine SMV along with other non-forfeiture options provided in the contract language to determine what's in the client's best interest. The longevity analysis component of the SMV process is also a valuable data point for the strategies we discussed for any senior clients wishing to initiate the purchase of additional coverage.

Endnotes

1. Portability refers to the ability to transfer the used estate tax exemption of the first spouse to die to the surviving spouse. Portability must be elected on the timely filed estate tax return (Form 706) of the first spouse to die.
2. The nuclear option is a parliamentary procedure that allows the Senate to override a rule or precedent by a simple majority of 51 votes, instead of by a supermajority of 60 votes. It was applied during the confirmation of Justice Neil Gorsuch to eliminate the requirement that ending a filibuster of a U.S. Supreme Court nominee requires the consent of 60 senators.
3. *www.cbpp.org/research/federal-tax/ten-facts-you-should-know-about-the-federal-estate-tax*.
4. *www.brookings.edu/wp-content/uploads/2016/02/execsummary_chapter4_laterretirement_inequality_longevity.pdf*.
5. Internal Revenue Code Section 672(c) provides some guidance regarding who would qualify as an "independent trustee." An independent trustee is generally considered to be someone who isn't a grantor or beneficiary of the trust, or related or subordinate to a grantor or beneficiary of the trust.
6. *See Estate of Knipp v. Commissioner*, 25 TC 153 (1955), *acq. in result*, 1959-1 CB 4; Revenue Ruling 83-147.
7. *See Estate of Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir. 1999) and *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005).
8. *Grigsby v. Russell*, 222 U.S. (1911).
9. *Ibid.*, at p. 156.
10. Jon B. Mendelsohn, "Rethinking Life Insurance Valuation for Seniors," *Trusts & Estates* (November 2016), at p. 40.