ESTATE PLANNING COUNCIL OF DELAWARE

THE END OF LIFE FOR INSURANCE IN THE ESTATE PLAN—DEATH BENEFIT, SURRENDER, LAPSE OR SETTLEMENT?

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A. Introduction. In developing an estate plan for wealthy clients, insurance can often play a key role. This paper seeks to review (i) why wealthy clients purchase life insurance, (ii) the types of life insurance that are available and which are most often utilized in an estate plan, (iii) the reasons why life insurance, once the contract matures, may no longer be advisable or desired—this has been described as the "crossover point" when continued financial investment in the contract may not yield an optimal result[1], and (iv) strategies for exiting a life insurance contract if insurance will not be maintained, including engaging in a life settlement transaction.

Arising from a somewhat sordid history, the life settlement market has developed to be a multi-billion dollar sophisticated institutional investment space that, similar to Sotheby's and Christie's, requires individuals who are willing to sell their property—in this case existing life insurance contracts. As most people understand, once a life insurance contract is purchased, there are only four possible outcomes—(1) a death benefit is paid, (2) the contract is surrendered for the cash surrender value, (3) the policy lapses, or (4) the policy is sold in a life settlement transaction. However, it is the fourth option that most advisors to high net worth and ultra-high net worth clients, along with the clients themselves, are totally unfamiliar with. In fact, until June of 2017, this author personally had no idea that a life insurance policy could be sold.

The ability to sell life insurance in a purchase and sale transaction is not a new idea, and the authority for a policyowner to sell life insurance was initially confirmed by the United States Supreme Court in *Grigsby v. Russell* 110 years ago. *Grigsby v. Russell*, 32. S.Ct. 58 (1911) (holding that the owner of a life insurance policy can assign the policy to a person having no insurable interest in exchange for money and the agreement to pay the premiums due). Today, the

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[1] *See* Pauloski, Thomas J. and Andrew T. Bishop, "Triangulation: Integrating Life Insurance into the Estate and Investment Plans", Bernstein Private Wealth Management (2019).

insurance laws of 43 states regulate the sale of life insurance to protect the interests of the parties to a life settlement transaction[2], and the insurance laws in Texas further clarify that an insured, owner or annuitant is authorized to assign, "in accordance with the terms of the policy or contract:

(1) any benefits to be provided under an insurance policy or annuity contract…; or

(2) any other rights under the policy or contract." Tex. Ins. Code § 1108.101.[3]

B. Why Do Wealthy Clients Purchase Life Insurance? In my estate planning practice, I regularly work with wealthy clients who have existing insurance and also advise clients regarding purchasing additional insurance or replace existing coverage in connection with establishing their estate plan. At the time the decision to purchase additional insurance is made, the decision is well reasoned and a financial decision that requires coordination among the professional advisors to the client. These advisors include me, as the estate planning attorney, and one or more of the client's financial advisor, insurance advisor (if the financial advisor is not licensed to sell insurance), and accountant. However, the experience many individuals have with purchasing life insurance may not be the same. Life insurance is vulnerable to being aggressively sold by advisors who may not fully understand the complexity of the products themselves or the host of tax and other laws related to income and estate planning, and too often, insurance is not thoughtfully purchased with the assistance of an experienced advisory team. Regardless of how acquired, as an estate planning professional, the goal is to work with the client's existing life insurance or newly acquired life insurance to ensure the tax efficient transfer at the death of the insured. If there is a question

[2] Alabama, Missouri, South Carolina, South Dakota, and Wyoming do not impose any restrictions on the sale of a life insurance policy, while Michigan and New Mexico regulate viatical settlements, but not life settlements. The difference between a viatical settlement and a life settlement relates to the health of the insured. A viatical settlement generally is available only when the life expectancy of the insured is 24 months or less. I.R.C. §101(g); *see* Exhibit A and https://www.lisa.org/regulations-overview/.

[3] Other states specifically authorize the sale of life insurance, including Delaware pursuant to the Delaware Viatical Settlements Act, *see* 72 Del. Laws c. 132.

regarding whether an insurance policy should be maintained, coordination with a life insurance and financial advisor is required and, for permanent insurance, current in force illustrations should be obtained and a policy audit performed.

Since 54 percent of all people in the United States have some type of life insurance coverage, understanding life insurance is important for all estate planning attorneys. LIMRA 2020 Insurance Barometer Study (2021). Although one may expect that wealthy individuals are more likely to purchase life insurance since they have more disposable resources and wealth to protect from transfer taxes, the percentage of high net worth, ultra-high net worth and mass affluent individuals actually seem to own life insurance at the same rate. Spectrem Group Study, https://spectrem.com/Content/-do-wealthy-investors-own-life-insurance.aspx (2018). The foregoing may be explained by each segment of these populations choosing to purchase insurance for different reasons. At the lower level of income and net worth, the purpose of life insurance may be income replacement and/or liquidity, whereas at the higher level of income and net worth, the purpose of life insurance may be asset protection, liquidity for estate taxes, estate tax replacement, liquidity for income taxes for IRD assets and legacy for beneficiaries, or a combination of all of these purposes.

With respect to asset protection, under Texas law, the cash value and proceeds of an insurance policy are fully exempt from:

> (A) garnishment, attachment, execution, or other seizure;
>
> (B) seizure, appropriation, or application by any legal or equitable process or by operation of law to pay a debt or other liability of an insured or of a beneficiary, either before or after the benefits are provided; and

(C) a demand in a bankruptcy proceeding of the insured or beneficiary. Tex. Ins. Code § 1108.051.

Accordingly, clients who are concerned regarding personal and/or professional liability may choose to invest in life insurance products that focus on the build-up of cash value which would be protected in the event of a bankruptcy or other adverse creditor event. Of course, estate planning techniques, such as completed gifts to spendthrift trusts for the benefit of family members that are not transfers to defraud a creditor, similarly place assets outside of the reach of creditors.

1. Life Insurance for Income Replacement and Additional Liquidity. Perhaps the most straightforward form of life insurance would be inexpensive term insurance purchased for the purpose of replacing income of an earning spouse. It is not uncommon for wealthy clients to be high earners and high spenders with spouses and dependents who may not be able to maintain their lifestyle if the high earning spouse was to pass.

CASE STUDY: Micah Medical is a wealthy doctor earning $1.5 million per year. After taxes and expenses, including an expensive home and private school tuition for his four children, he is limited in his ability to increase his savings outside of his retirement plan. Although his wife is an attorney, she has not worked as a lawyer for over ten years and has been focused on raising their family. The couple lives in a $2.5 million home with a $1.5 million mortgage and their savings are mostly retirement plan savings of $1.5 million. Although Micah is a partner in his medical practice, if he dies there are no mandatory buyout provisions under his shareholder's agreement and his interest in the medical practice essentially will expire worthless. The foregoing fact pattern illustrates a need for income replacement and additional liquidity, particularly if the family wishes to maintain their standard of living until the children are all over age 22 and pay for the costs of higher education. A present value analysis of Micah's lost income stream should be combined

with a similar analysis of the amounts required to support the family and consideration of the future value of existing assets and the income and earnings from the investment of any death benefit received (since the entirety will not be consumed in the immediate term) to develop a range of the appropriate amount of term life insurance. Only examining the lost income stream of Micah as the earning spouse and looking to replace this income through the life expectancy of the surviving spouse may not provide the optimal level of insurance required.

2. Liquidity and Income and Estate Tax Replacement. Clients of significant wealth with a taxable estate[4] may be concerned about having sufficient access to cash or readily marketable assets for purposes of payment of the estate tax, which is generally due within 9 months of the date of death of a decedent. Although there may be options pay taxes on certain assets in installments under I.R.C. § 6166, these taxes ultimately must be paid and a source of funds for the payment of estate taxes must be identified and realized. In addition, clients who have assets or rights to compensation that may trigger significant income taxes as result of their death[5] or have made lifetime gifts of assets that will generate significant income taxes when sold after the donor's death, may wish to purchase life insurance for income as well as estate tax replacement. Clients with closely held business, illiquid investments, or significant collections of tangible personal property that may be difficult to borrow against or sell efficiently without hefty transaction costs or commissions, such as artwork, may consider purchasing life insurance to provide a source of liquidity for estate taxes.

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[4] Under current law, only estates in excess of $11.7 million for a single person, or a combined $23.4 million for a married couple, are subject to estate tax. I.R.C. § 2010(c)

[5] IRD assets are assets that have untaxed income that is realized upon the death of the person who had the right to receive that income. I.R.C. § 691. The most common sources of IRD are compensation income and retirement plan income. IRD must be included in gross income by the estate or the person who acquires the right to receive the income. I.R.C. § 691(c) allows for a deduction for the estate tax paid with respect to the IRD, but this is a deduction and not a credit.

CASE STUDY: Cathy Collector owns an art gallery and after years of collecting emerging artists, owns a collection of artwork worth around $25 million. In addition to her artwork and gallery which has independent value of an estimated $2 million, Cathy has $5 million in liquid assets and a $3 million residence. Cathy is unmarried and wishes to give her $35 million estate, including her artwork, to her brother and sister (or their descendants), in lifetime trusts when she passes. Cathy does not have any charitable interests or intent. In the event of Cathy's passing under current law, there would be an estimated estate tax of $9.3 million[6], without taking into account any appreciation in Cathy's assets through her life expectancy or a possible reduction in the estate tax exemption or an increase in the income and estate tax rates, including the potential for increased capital gains tax rates and such tax to be due at Cathy's death, all of which are included in current or prospective tax legislation.[7] The entirety of Cathy's liquid assets would be consumed by estate taxes and there would still be a deficiency in assets available to pay the estate tax due. Guaranteed universal life insurance, properly placed in an irrevocable life insurance trust ("ILIT"), may provide some additional liquidity to pay estate taxes, and certain estate planning transfer tax techniques designed to efficiently transfer the interest in Cathy's artwork to her desired beneficiaries may also reduce Cathy's taxable estate. The amount of life insurance to be acquired would be a decision made among Cathy and her insurance, financial and estate planning advisors.

3. Diversification and Tax Efficient Investment. The income tax treatment of life insurance is very favorable to policyholders and their beneficiaries. For cash-value life insurance policies, the investment savings within the insurance contract grows without income tax consequences.

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[6] The foregoing assumes an $11.7 million basic exclusion amount and a 40% estate tax rate. I.R.C. §§ 2001(c) and 2010(c).

[7] *See e.g.*, H.R. 2286, March 29, 2021; Sensible Taxation and Equity Promotion ("STEP") Act of 2021, March 29, 2021; S. 994, For the 99.5 Percent Act (2021), March 25, 2021; H.R 2576, April 15, 2021; American Families Plan Proposal, April 28, 2021; General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, Dept. of Treasury, May 2021.

I.R.C. § 7702(g). In addition, if the policy is held until the insured's death, no income taxes will be due on the receipt by the beneficiary of the difference between the cumulative premium payments and the amount of the death benefit. I.R.C. § 101(a). However, life insurance gains are taxable when the policyholder surrenders or sells a policy during his or her lifetime, and for a policy surrender (non-MEC[8]), only the difference between the investment in the insurance contract (premiums paid less amounts received) and the cash surrender value, if greater, is taxable as ordinary income. I.R.C. § 72(e)(3)(A).

Considering the favorable income tax treatment of the build-up of cash value within a life insurance policy and the income-tax free treatment of the payment of the death benefit to the desired beneficiaries, combined with the asset protection afforded under the laws of certain states, such as Texas under Tex. Ins. Code § 1108.051, some clients choose to invest in life insurance as part of a tax efficient and creditor-protected retirement savings plan. Other clients who have significant risk in their day-to-day operating business or investments may wish to invest in insurance as a diversified safe investment that appreciates and accumulates income on a tax advantaged basis.

CASE STUDY: Lex Legal is a successful commercial litigator in Austin, Texas. Lex is a high earner and is concerned about the active Texas plaintiff's bar and potential malpractice liability. Lex enjoys skeet shooting and flying friends in his two-seater airplane. Despite his risk loving hobbies, Lex has a conservative personal investment strategy, and during his retirement would like to purchase a ranch outside of Austin where he can shoot at his range and build a hangar and

[8] I.R.C. § 7702A defines "modified endowment contracts," which are contracts that fail to satisfy certain requirements. The income taxation of modified endowment contracts is governed by I.R.C. § 72(e)(10), rather than by I.R.C. § 72(e)(5)(C), which causes amounts received under modified endowment contracts first as taxable income and then as return of basis. Clients should carefully consider the purposes of modified endowment contracts as the ability to access the cash value on a tax-advantaged basis is limited.

runway for his plane. Lex is already contributing the maximum annual amount to his firm's retirement plan and was advised by his insurance and financial advisors to consider investment in a whole life insurance contract that would be protected from creditor claims under Texas law and provide a source of income tax free funds during retirement. The following is an illustration of the whole life policy designed for Lex to be intentionally overfunded for rapid wealth accumulation while avoiding being a MEC that looks to achieve Lex's stated goals for asset protection, diversification and efficient income tax free growth and appreciation within the contract:

Internal Rate of Return Summary

Base Policy Face Amount: $5,000,000
Initial Death Benefit Amount: $5,000,000
Premium Paying Period: 10 years

Premium Mode: Annual
Dividend Option: Paid-Up Additions

Life insurance policies provide immediate death benefit protection and long term tax deferred cash value accumulation. The **Cumulative Internal Rate of Return** (IRR) is an important way to measure your Custom Whole Life policy's performance. It is equivalent to the interest rate at which the illustrated Annual Policy Cash Flow would have to be invested outside the policy (ignoring taxes) to arrive at the cash value or death benefit of the policy when non-guaranteed dividends are factored in. The Cumulative IRR is compounded annually, and assumes that all payments are paid at the beginning of each policy year.

End of Year	Age	Annual Policy Cash Flow	Cumulative IRR on Cash Surrender Value	Cumulative IRR on Death Benefit	Cash Surrender Value	Death Benefit (BOY)
1	46	188,700	-100.00%	2,549.71%	0	5,000,000
2	47	188,700	-61.45%	367.18%	100,800	5,000,000
3	48	188,700	-30.14%	158.34%	288,258	5,000,533
4	49	188,700	-17.04%	92.52%	483,578	5,001,401
5	50	188,700	-10.29%	61.95%	689,269	5,002,754
6	51	188,700	-6.24%	44.80%	909,148	5,011,651
7	52	188,700	-3.61%	34.07%	1,143,356	5,038,471
8	53	188,700	-1.79%	26.83%	1,392,733	5,081,425
9	54	188,700	-0.48%	21.70%	1,658,091	5,140,304
10	55	188,700	0.61%	17.92%	1,951,104	5,214,750
11	56	0	1.34%	15.78%	2,059,599	5,333,800
12	57	0	1.87%	14.11%	2,171,966	5,450,982
13	58	0	2.28%	12.79%	2,290,687	5,566,431
14	59	0	2.61%	11.72%	2,416,189	5,686,345
15	60	0	2.87%	10.85%	2,548,642	5,810,939
16	61	0	3.09%	10.12%	2,688,441	5,940,337
17	62	0	3.28%	9.51%	2,835,824	6,074,886
18	63	0	3.43%	8.99%	2,991,042	6,214,824
19	64	0	3.57%	8.53%	3,154,312	6,360,264
20	65	0	3.69%	8.14%	3,326,117	6,511,255
21	66	0	3.79%	7.80%	3,504,284	6,668,104
22	67	0	3.87%	7.49%	3,691,351	6,826,039
23	68	0	3.95%	7.22%	3,886,904	6,989,342
24	69	0	4.01%	6.97%	4,091,393	7,156,621
25	70	-293,430	4.07%	6.61%	4,002,080	6,808,892
26	71	-293,430	4.13%	6.29%	3,908,762	6,470,353
27	72	-293,430	4.17%	6.02%	3,811,256	6,141,024
28	73	-293,430	4.21%	5.79%	3,709,042	5,820,835
29	74	-293,430	4.25%	5.59%	3,601,877	5,508,922

Reflects non-guaranteed values and benefits which are based on assumptions that are subject to change by the insurer; therefore, actual results may be more or less favorable.
This is a supplemental illustration which is not valid without the attached basic illustration. Refer to the basic illustration for guaranteed values and benefits and other important information.

Lex's policy has been designed for cash withdrawal beginning at age 70, presumably around retirement age, but there is flexibility in the contract should he wish to borrow against the policy or make cash withdrawals prior. The death benefit in Lex's contract, assuming withdrawals at the illustrated amount, will decline through life expectancy which is illustrated as follows:

New York Life Insurance Company
New York Life Custom Whole Life Insurance
Supplemental Illustration

Internal Rate of Return Summary (cont.)

End of Year	Age	Annual Policy Cash Flow	Cumulative IRR on Cash Surrender Value	Cumulative IRR on Death Benefit	Cash Surrender Value	Death Benefit (BOY)
30	75	-293,430	4.28%	5.42%	3,489,420	5,204,925
31	76	-293,430	4.31%	5.32%	3,369,061	4,994,469
32	77	-293,430	4.33%	5.26%	3,238,957	4,840,871
33	78	-293,430	4.34%	5.21%	3,098,062	4,674,722
34	79	-293,430	4.35%	5.16%	2,947,136	4,493,959
35	80	-293,430	4.36%	5.11%	2,785,222	4,299,858
36	81	-293,430	4.37%	5.06%	2,611,676	4,091,579
37	82	-293,430	4.37%	5.01%	2,425,540	3,868,670
38	83	-293,430	4.37%	4.96%	2,225,968	3,630,520
39	84	-293,430	4.37%	4.92%	2,011,927	3,376,214
40	85	-293,430	4.37%	4.87%	1,782,420	3,106,189
41	86	-293,430	4.36%	4.83%	1,536,284	2,820,087
42	87&	-293,430	4.35%	4.79%	1,272,257	2,517,649
43	88	-293,430	4.34%	4.75%	989,177	2,198,489
44	89	-293,430	4.32%	4.71%	685,372	1,862,247
45	90	0	4.30%	4.66%	660,872	1,801,565

Contributing a whole life policy designed for income tax free appreciation and retirement planning to a life insurance trust, described in the next section, presents a challenge because the insured is not then able to benefit from the policy cash value during retirement. In addition, if there is significant value already accumulated in the policy, the transfer tax cost of the policy may be higher, making it a less efficient asset for wealth transfer than a new contract initially acquired in trust.

4. <u>Irrevocable Life Insurance Trusts</u>. Although life insurance generally is exempt from income tax within the contract and when the death benefit is paid, life insurance is subject to estate

tax at the death of the insured if the insured retained any incidents of ownership[9] with respect to the contract at the death of the insured or within three years of the insured's death. I.R.C. §§ 101(a)(1); 2042 and 2035. Considering the foregoing, most wealthy clients are counseled to acquire or transfer existing life insurance, especially life insurance that would cause the client's estate to be in excess of the estate tax exemption, to a properly structured life insurance trust to protect the death benefit from estate tax at the death of the insured or the surviving spouse of the insured. Depending on when the insured dies, trust owned insurance can provide significant leverage of the gift, estate and GST tax exemptions.

A gift of life insurance is subject to gift tax, and whether the transfer of the policy qualifies for the annual exclusion under I.R.C. § 2503(b) depends on the terms of the insurance trust and other gifts made to the trust beneficiaries prior to the gift of the insurance. For example, if the beneficiaries of the insurance trust have Crummey withdrawal rights, a gift of life insurance to the trust should qualify as a gift of a present interest, and the annual exclusion would be applicable. *See, e.g.*, Priv. Ltr. Rul. 8134135; Priv. Ltr. Rul. 8111123 (contribution qualified for gift tax annual exclusion where beneficiaries had withdrawal rights that could be satisfied with "[a]ny trust assets, including any life insurance policies"); Priv. Ltr. Rul. 8021058; *but see* Priv. Ltr. Rul. 8118051 (contribution to trust qualified for gift tax annual exclusion where beneficiary had withdrawal right but only "to the extent that there is cash, or assets reducible to cash, in the trust to satisfy any beneficiary demand rights.")

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[9] *See* Treas. Reg. § 20.2042-1(c)(2) (stating "the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.").

Although it is possible to make a gift of existing life insurance to an ILIT to transfer the insurance outside of the taxable estate, some clients may wish to sell existing life insurance to a grantor trust with respect to the insured to avoid the application of I.R.C. § 2035 and the transfer-for-value rule under I.R.C. § 101(a)(2) should the insured die within three years of a gift transfer. *See* I.R.C. § 101(a)(2)(B) (providing for certain exceptions to the transfer-for-value rule that would otherwise cause the death benefit to be taxable as ordinary income to the purchaser if the policy was sold during the lifetime of the insured and providing that a transfer to the insured is included as one of these exceptions). Since only a transfer for less than full and adequate consideration is a gift within the meaning of I.R.C. §§ 2511 and 2512, a sale of existing life insurance for full and adequate consideration should not result in a taxable gift and would avoid the application of I.R.C. § 2035 if the insured died within three years of the gift transfer. The valuation of life insurance and the determination of whether full fair market value has been paid in a sale transaction to a intentionally defective grantor trust is beyond the scope of this paper; however, determining the value of the policy should be noted as a risk in any sale of life insurance if the goal is to avoid a taxable gift and remove the life insurance from the taxable estate and the reach of I.R.C. § 2035.[10]

[10] Treas. Reg. § 25. 2512-6(a) sets forth the federal gift tax rules applicable to life insurance and relies on the cost of a "comparable" policy, since there traditionally was no market for life insurance policies. Recognizing that the "valuation of an insurance policy through the sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made", the Regulations provide that "the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date." With respect to the determination of the interpolated terminal reserve, the practice of carriers in reporting values on a Form 712 is not consistent, with some only reporting the ITR value and some others reporting the policy cash value or its surrender value. Most carriers have begun providing a series of values for a policy, leaving the determination (which they take the position is a legal issue, on which they do not advise) up to the taxpayer and his or her advisers. For example, Lincoln Financial recently provided a valuation letter to our client stating, "Lincoln takes no position with respect to the proper method of valuation for any policy. You should consult with your tax advisor concerning the proper valuation of your Policy for tax purposes." Practitioners and insurance advisors have both observed that the gift value reported on Forms 712 may be substantially higher than cash values and the annual premium for level-term insurance. The take-away to the practitioner is that it can be extremely challenging to confirm the gift tax value of existing insurance. However, the life settlement market further discussed later in this paper introduces an opportunity for a fair market value based on the willing buyer/willing seller standard under I.R.C. § 2512 and the corresponding Treasury Regulations.

5. Investment in Life Insurance as a Hedge Against an Early Death.

Estate planning professionals who recommend life insurance for wealthy clients who otherwise have sufficient liquidity to replace income lost by the death of an earning spouse or to replace income and estate taxes resulting from death often make this recommendation to provide a hedge in the estate plan against an early death before the other transfer tax techniques being developed by such professionals have had the opportunity to mature. In addition, with the increase in the use of spousal lifetime access trusts ("SLATs") because of the increase in the value of the lifetime gift, estate and GST exemptions over recent years to an unprecedented $11.7 million per person, life insurance may provide a source of liquidity to the spouse who is not the SLAT beneficiary should that spouse die early.[11]

When an insured dies early, the investment in life insurance is an extremely profitable investment. Permanent life insurance illustrations project internal rates of return or "IRRs" throughout the insured's life expectancy. As shown in the Lex Legal policy illustration beginning on page 10 above, the IRR on an investment in the whole life contract is extremely high in the early years of the contract at 2,549.71%, but at life expectancy (which we will assume is around 90 years of age), the IRRs are 4.3% and the death benefit decreases to $1.8 million. Although these IRRs may look similar to reasonable rates of return from other taxable investments, such as a diversified portfolio of securities, on an after-tax basis, whether the contract performs as illustrated and yields the intended result is a function of the contract itself. And, it makes sense, of course, that life insurance as an investment strategy will yield a greater overall returns to the investment in the contract if the

[11] In the SLAT structure, the donee spouse is a beneficiary of an inter vivos trust (which may also include children and more remote descendants as beneficiaries) while the donor spouse is not. Often the beneficiary spouse is also the trustee. At the death of the beneficiary spouse, if there is no power of appointment available or exercised in favor of the donor spouse, the donor spouse will lose access to the assets contributed to the SLAT that the donor spouse theoretically had during the lifetime of the beneficiary spouse and while the spouse's remained married.

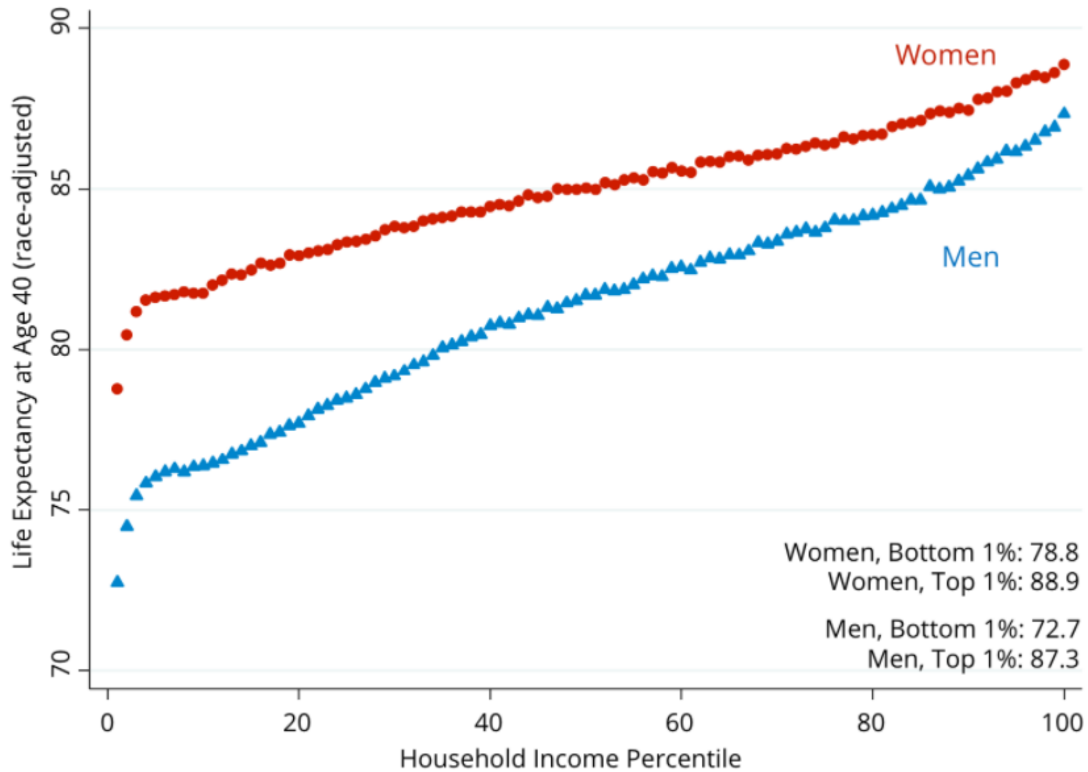
insured (or insureds for a survivorship policy) die prior to life expectancy. The mortality risk component of life insurance, in fact, is the feature that leads many wealthy individuals to purchase life insurance as one of the initial steps in developing an estate plan. The foregoing reflects a universally accepted simple truth—none of us knows when we may pass, and life insurance will pay a death benefit if the contract is maintained regardless of whether one day or 30 years have passed since the insurance was purchased.

Although none of us knows when he or she may die, wealthy persons live significantly longer than less wealthy persons. The average life expectancies for under the Updated Static Mortality Tables for Defined Benefit Pension Plans for 2018, IRS Notice 2017-60, are as follows:

Age	MALE	MALE	MALE	FEMALE	FEMALE	FEMALE
	2018 Non-Annuitant Mortality Rate	2018 Annuitant Mortality Rate	2018 Optional Combined Table for Small Plans	2018 Non-Annuitant Mortality Rate	2018 Annuitant Mortality Rate	2018 Optional Combined Table for Small Plans
80	0.050067	0.050067	0.050067	0.038490	0.038490	0.038490
81	0.057467	0.057467	0.057467	0.042601	0.042601	0.042601
82	0.065843	0.065843	0.065843	0.047227	0.047227	0.047227
83	0.073396	0.073396	0.073396	0.052439	0.052439	0.052439

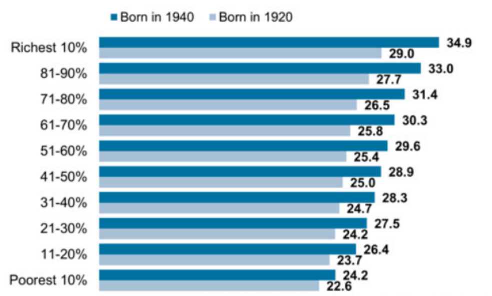
and show that the average life expectancy for males in the United States is age 80 and for females is between 82 and 83. However, the top 1% of income earners in the United States can be expected to live 15 years longer for men and 10 years longer for women, with average life expectancies of 87.3 years and 88.9 years for these wealthiest men and women, respectively.[12]

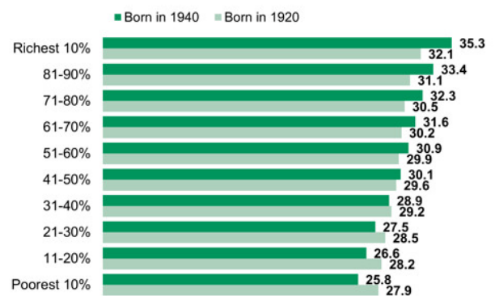
[12] The Equality of Opportunity Project, http://www.equality-of-opportunity.org/health/ (2016).



The richest American men live 15 years longer than the poorest men, while the richest American women live 10 years longer than the poorest women.

A 2014 study by economist Barry Bosworth at the Brookings Institution found that that the wealthiest 10% of the population that has already reached 55 years of age can be expected to live an additional 35 years for both men and women.[13]





Considering that the wealthiest portion of our population can be expected to live the longest, life insurance as a hedge against an early death is unlikely to pay off early and result in large returns to the investment in the life insurance contract because our wealthy clients have a 50% chance of living longer than age 90. In fact, most term and permanent life insurance policies actually terminate or lapse before they pay a death benefit, and the statistic often cited is that 88% of all universal life insurance contracts are either surrendered or lapse before ever paying a death benefit.[14] The foregoing seems to be a correct conclusion from what we have just reviewed—that is, (i) wealthy people have discretionary funds to invest in life insurance, (ii) wealthy people live longer, (iii) wealthy people have resources to engage in other sophisticated estate planning techniques not covered by this paper, and (iv) the data shows that wealthy people, at some point, choose to no longer continue their investment in a life insurance contract and either surrender the contract or allow it to lapse.

According to a 2016 Olin Business School, Washington University and Wharton School, University of Pennsylvania study (the "Olin Wharton Study"),

[14] Per the Milliam USA (2004) study, (i) almost 85% of term policies fail to pay a death claim; (ii) nearly 88% of universal life policies ultimately do not terminate with a death benefit claim; and (iii) 74% of term policies and 76% of universal life policies sold to seniors at age 65 never pay a claim. *See* Gottlieb, Daniel and Kent Smetters, "Lapsed Based Insurance", Olin Business School, Washington University and Wharton School, University of Pennsylvania (June 6, 2016), https://faculty.wharton.upenn.edu/wp-content/uploads/2016/11/Insurance41.pdf.

> Virtually all life insurance policies are front loaded, as policyholders pay more than the actuarial cost of their contemporaneous mortality risk early into the policy in exchange for paying less than their actuarial cost later on. The majority of individual policies, however, never reach their maximum term or pay a death benefit. Instead, policyholders voluntarily terminate them, thereby losing their front load. Specifically, most term policies, which offer coverage for a fixed number of years, lapse prior to the end of the term, as about one in every 14 customers stop paying premiums each year. Similarly, most permanent policies are surrendered (i.e., lapsed and a cash value is paid) before death or their expiration at age 100 or older.[15]

The Olin Wharton Study finds that "life insurance companies earn large profits on clients who terminate their policies, since policies are often terminated before mortality increases sufficiently above premiums paid," and that policyowners who allow their contracts to lapse "cross-subsidize those who keep their coverage." The Olin Wharton Study further finds that "competitive pressure not only forces insurers to compete on [making a profit from policies that lapse]; life insurers must endogenously adopt front loads to encourage lapses." The Olin Wharton Study also examines the compensation structure of life insurance agents, which is almost entirely front loaded, and finds that this structure encourages the sale of life insurance policies without the ongoing requirement for the agent, who has already been compensated, to develop an ongoing relationship with the client. The Olin Wharton Study states:

> First, commissions are endogenous; companies choose how to structure their sales commissions. An explanation for front-loaded premiums that is based on the fact

[15] *Id.* at 1.

> that sales commissions are front loaded needs to justify why commissions are front loaded in the first place. In fact, commissions paid to insurance brokers highly encourage selling to shorter-term consumers. While their commissions may last several years, the bulk of the payment is typically made in the first or second year. However, commissions are often not paid if the policy is surrendered in the first year since then the insurer could lose money. In contrast, commissions paid to wealth managers, for example, are fairly proportional to the actual fee revenue collected from clients, thereby encouraging the wealth manager to keep the relationship active. Our model suggests that front-loaded commissions may be used to incentivize insurance brokers to find clients without concern for whether they will hold their policies for very long.[16]

The failure of insurance agents to be properly incentivized through compensation from the insurance carriers to continue to service contracts once placed and perform periodic policy audits would seemingly also increase the lapse ratio because insurance policies that are not properly funded and do not perform as illustrated are more vulnerable to lapse if the client remains uniformed that the contract is underperforming and later does not wish to pay significant catch-up premiums to maintain the coverage.

C. Types of Life Insurance Commonly Used in Estate Planning.[17] The most common types of life insurance policies used in connection with estate planning include term insurance and permanent insurance.

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[16] *Id.* at 26-27.
[17] A significant resource for the information and discussion in this Section C is Lee, Gary R. and Craig Wilkey, Portfolio 827-2nd: Life Insurance—A Practical Guide for Evaluating Policies (Bloomberg Tax 2021).

1. Term Insurance. Although group term or employer provided term insurance may be a key employee benefit, it may be difficult to plan with from an estate planning perspective for a variety of reasons, most notability the lack of portability because if the employee leaves employment, the group term insurance ceases or the employer may not agree to roll the coverage out to the employee. Employer provided insurance can also present issues in estate planning even if portable for funding ILITs in community property states, such as Texas, if the spouse will be a beneficiary of the trust because an ILIT funded with community property, such as employer provided insurance and the related premium payments, will be includible in the estate of the surviving spouse if such property is not effectively partitioned in advance of being contributed to the ILIT. Most estate plans for younger clients rely on level term insurance coverage because this is the most cost-effective coverage to insure the risk of an untimely death before wealth has had the opportunity to develop and grow. Level term insurance coverage is less costly because the risk of death of the insured in the early years is extremely low. Level term insurance provides a guaranteed death benefit over a term of years for the payment of an established term premium and often has conversion rights which allow the policyowner to convert the coverage during or at the expiration of the level term period to permanent insurance without additional medical underwriting or other evidence of insurability. The term conversion option allows individuals to "lock-in" their insurability at the face value of the term policy while keeping their out-of-pocket life insurance costs lower than comparable permanent insurance coverage; however, conversion permanent policy options at the expiration of the term may be priced higher by the carrier to address this risk to the insurance company of the decline in insurability. Accordingly, if conversion is a consideration, which it should be for the well-advised client since we never know how an individual's health may develop, insureds should consider the cost of converting term coverage

into a permanent contract with any proposed term insurance carrier in advance of purchasing the term insurance policy. Depending on the anticipated insurance needs, paying a slightly higher term premium to place the coverage with a carrier with more favorable conversion terms may be advisable.

2. Permanent Insurance. Permanent insurance is referred to as such, but that can actually be a misnomer. Permanent insurance is only "permanent" if the insurance policy is properly funded and maintained throughout the life of the insured. Permanent insurance offers a death benefit through a certain age that is greater than average life expectancy, for example through 105 or 120, and carries with it an income-tax free investment component known as the cash value account. The cash value account receives premium contributions in the earlier years of the permanent insurance policy contract that are greater than the mortality charges and other costs of insurance under the contract during that year. The excess amounts contributed to the cash value account via these excess premiums then appreciate over the term of the contract income-tax free and, if properly funded over the life of the policy, should result in the cash value account holding sufficient assets during the later years of the contract to cover the increased risk of mortality and higher costs of insurance required to maintain the contract through the life of the insured.

a. Whole Life Insurance. For traditional whole life insurance, the cash value account should be designed and funded to grow to an amount equal to the death benefit at the age specified in the contract, such as age 100 or a later date, assuming no dividends are credited to the policy. Whole life insurance is often the most expensive coverage with the highest premium cost because the insurance carrier is required to make certain guarantees with respect to future premium pricing and growth in the contract's cash account. The policyowner usually chooses to pay into the whole life insurance contract over a certain period of years, such as 10, 15 or 20 years. The guaranteed

cash value may be less than other investment opportunities and fees can be high, depending on the insurance carrier and whole life product selected.

Whole life insurance is often purchased for tax-free investment and diversification, as illustrated above in the Lex Legal case study, and the primary goal of the policyowner may be to increase additional retirement savings, with the secondary goal being the receipt by the desired beneficiaries of the death benefit. The dividends illustrated in whole life insurance policy illustrations are not guaranteed but are estimates of the insurance company's earnings, expenses and mortality charges. Dividends on a whole life contract may be paid in cash, paid to reduce future premium payments, allowed to accumulate within the policy or used to purchase additional insurance. Whole life insurance can be blended with term insurance to reduce the costs of the whole life insurance contract and provide premium flexibility; however, depending on the actual policy dividends relative to the premiums paid-in, whole life term blend products may be vulnerable to lapse unlike a standard whole life guaranteed contract. Unlike universal life insurance, whole life insurance contracts do not provide flexibility in the premiums required over the term of the policy to maintain the contract.

b. Universal Life Insurance. Universal life insurance ("UL") usually offers greater flexibility to the policyowner than an investment in a whole life insurance contract. Under a UL insurance contract, the insurance carrier guarantees the death benefit only if there is sufficient value in the cash account to pay the mortality and expense charges under the contract, and these expenses can increase during the term of the contract in accordance with the policy. The insurance company is not obligated to guarantee a level premium, and the policyowner assumes the investment risk that the investment account will not perform as illustrated or that expenses may be higher than as originally estimated. UL policies usually have two cash account values—the cash

value account and the cash surrender value account. The cash value account is used to calculate the net amount at risk under the contract and for interest crediting purposes. The cash surrender value account is the amount that will be paid to the policyowner if the contract is surrendered. Accordingly, the insurance company retains part of the cash value via the contract's "surrender charge" to compensate the carrier for a lapse or early policy termination. UL contracts can have a minimum premium designed to keep the policy in force for the current year or through a certain age and a target premium that is the recommended amount that should be paid on the policy to cover the cost of insurance and keep the policy in force through an age beyond life expectancy, such as 105 or 120.

UL contracts are commonly used in estate planning and may be intentionally underfunded in the early years of the contract to minimize the cost of the insurance coverage while providing the option to increase premiums in later years if the coverage is advisable to maintain. Even if the contracts perform similar to the illustrations, these "catch-up" premiums can be significant and the estate planner should be aware of these additional costs, especially if lifetime gift and GST tax exemptions will be fully utilized for other transfer tax planning techniques.

Some universal life insurance products are designed to minimize cash value growth in favor of guaranteeing the death benefit. These guaranteed universal life contracts ("GULs"), allow for the insurance coverage to continue regardless of the cash value account as long as premium payments are timely made at the guaranteed premium amount. GULs are advisable for testamentary estate planning purposes if the continued need for the insurance, such as for estate tax replacement even if not for liquidity, exists. GUL contracts generally are not designed for maximizing the income-tax free investment component available within a life insurance policy. GUL contracts should be carefully managed by the insurance agent and the policyowner since these policies could terminate

or lose their guarantees, making them vulnerable to options within the contract that permit the insurance carrier to increase mortality and other costs of insurance under the contract, if premiums are not timely paid.

The investment strategy within a universal life contract can vary, and types of universal life contracts include indexed universal life ("IUL") and variable universal life ("VUL"). There is a cash portion of the IUL contract that is usually tied to a stock market index, such as the S&P 500 or another index selected, and there may be an option for a fixed-interest investment credit rating under the contract as well. If the index tied to the contract falls, there is a usually a floor that guarantees a minimum rate of return to be credited to the cash portion of the contract.

Concerns under UL contracts may arise because of the behavior of carrier, as well as from the agents themselves who sell UL products but are not properly incentivized by the carrier to work in the policyowner's best interests. The Center for Economic Justice issued a warning in July 2020 that consumers should not purchase universal life insurance citing misleading and deceptive sales practices. Because UL illustrations show non-guaranteed elements of the policy, and UL policies are just that—not guaranteed unless they are timely funded with the guaranteed premium, projections set forth in UL illustrations may never be realized. Accordingly, the policyowner should fully understand the risks associated with a UL contract and seek to work with a reputable insurance advisor willing to stress test and illustrate any UL policy being considered using more conservative assumptions.

VUL is similar to IUL; however, unlike IUL contracts, the policyowner determines how the cash account should be invested. VUL contacts are considered securities and are regulated by the SEC, FINRA and other governing bodies. Like IUL contracts, VULs provide for more flexible premiums and adjustable death benefits as compared to whole life insurance; however, unlike IUL

contracts, VUL policyowners decide how the cash value sub-accounts will be invested. Cash values within a VUL contract are not guaranteed; and the cash value and death benefit may increase or decrease over the duration of the contract depending on the investment performance of the investments selected. VUL contracts can have higher fees than other UL policies and can be extremely complex. Since the insurance company does not select the investments, VUL coverage may not be guaranteed, and there is risk associated with the death benefit which may make VUL coverage less desirable for testamentary estate planning and more suitable for clients willing to take investment risk to increase the value in the contract for income tax free withdrawal or borrowing during retirement.

3. Single and Joint Life Policies. Insurance can be purchased on one life or multiple lives and the death benefit can similarly be paid at the death of one or both insureds. Single life policies may be more suitable for income replacement of an earning spouse and additional liquidity, as reviewed in the Micha Medical case study, or for income tax replacement, for example if one spouse has a significant retirement benefit that would accelerate and become payable at death, and may also be used for estate tax replacement or liquidity for a married couple when only one spouse is insurable. Survivor or second-to-die policies pay a death benefit upon the death of the survivor of the insureds which may make survivor insurance policies more suitable for life insurance designed for estate tax replacement or liquidity for married persons because the death benefit pays at the time the insurance is required to pay estate taxes (assuming spouses remain married and there is a zero tax estate plan at the death of the first to die spouse) and the costs of the contract are generally lower because two lives are being insured. Both single and survivor policies can be term or permanent insurance policies.

4. Risks Under an Insurance Policy. As discussed above, insurance contracts do not always perform according to their illustrations, and since (i) life insurance is often optimistically and/or unrealistically illustrated by agents, and (ii) the assumptions under contracts reasonably illustrated may not prove correct, it may rarely be the case, other than for GUL contracts properly maintained, that an insurance illustration matches the actual performance of the policy. Even GUL contracts, however, must continue to be serviced. Recently, one of our clients failed to contribute the required premium to enable the corporate trustee to pay the guaranteed premium required on her $2 million insurance policy held in an ILIT. Instead of confirming the payment options and the guaranteed premium that had been paid during the prior years, Prudential sent the letter attached as Exhibit B, only informing the client that $7,677.17 was required to maintain the coverage. If this amount had been the only amount contributed, the policy would have lost its guarantee and been vulnerable to lapse. Fortunately, the insurance advisor was servicing the contract and contacted the corporate trustee and client to inform them of the correct guaranteed premium amount, $46,907, that is actually required to be paid to properly maintain the policy guarantee, and that amount was contributed within the grace period provided. The foregoing underscores that life insurance illustrations are extremely complex and communications from the carriers themselves can be deceptive, maybe intentionally so.

Clients should understand that the life insurance carrier is required to balance four main types of risk under an insurance contract: (i) mortality risk, (ii) interest rate/investment risk, (iii) expense risk, and (iv) lapse risk, and understandably, the carrier seeks to structure their insurance policies to shift these risks, to the greatest extent possible, to the policyowner.

a. Mortality Risk. The mortality risk within an insurance contract is the risk that the insured will die in a given year, and for nonguaranteed insurance products, such as IUL and VUL

contracts, the policyowner assumes the risk that mortality charges and cost of insurance will increase above the projections illustrated under the policy to the maximum mortality charges allowed under the contract. For a whole life contract, an increase in the cost of mortality could result in a lower dividend credit and a higher premium becoming due.

During 2015 and 2016 in response to continued low interest rate environments, each of Transamerica, Lincoln National Life Insurance Company, AXA Equitable Life Insurance Co. and Voya Financial increased costs of insurance being charged on existing in-force universal life insurance contracts, and Voya Financial ultimately exited the life insurance business at the end of 2018 but continues to service existing policies.[18] Although Transamerica settled two litigations relating to increased charges on their universal life policies, other class actions lawsuits are still pending. Since litigation is generally not the desired, certain or efficient path to maintaining insurance coverage, attention should be given to the expense risk under UL contracts.

b. <u>Interest Rate/Investment Risk</u>. Interest rate and investment risk under the contract relates to how the cash account (or sub-accounts) are credited over the term of the contract according to the policy terms. Under a whole life insurance contract, the insurance company assumes all risk of the contract up to the guaranteed cash value, and the policyowner assumes the risk that the dividend credit rating will exceed the guaranteed values and be credited to the policy. With respect to IUL contracts, the insurance company only guarantees a minimum interest crediting rating on the cash that remains in the policy which makes these contracts more vulnerable than whole life contracts because increased mortality charges and costs of insurance can reduce the cash amount, thereby reducing the amount that is credited to the cash value account. For VUL

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[18] Class action litigation was initiated against Transamerica (*Feller et. al. v. Transamerica Life Insurance Company* and *Thompson v. Transamerica Life Insurance Company*), Lincoln National (*Tutor v. Lincoln National Corp. et. al.*), and AXA (*Brach Family Foundation, Inc. v. AXA Equitable Life Insurance Company*).

contracts, the policyowner assumes all investment risk via the policyowner's choice of the investments to be held within the policy sub-accounts.

c. Insurance Expense. Insurance expense risks are born by both the insurance company and the policyowner, and maximum expenses charges are set forth under the terms of the policy. Since whole life contracts are illustrated with extremely conservative expense risk assumptions, increased dividends may result if costs are lower than anticipated, and if they are greater, the insurance carrier will assume these charges. For IUL and VUL contracts, expenses also can increase up to the policy maximums, and similar to whole life contracts, the insurance company assumes the risk of expenses in excess of these maximum amounts.

d. Lapse Risk. Lapse risk is the risk to the carrier that the policyowner will terminate the contract before the carrier's costs associated with placing the policy, such as sales commissions and other costs and fees, have been recovered. For IUL and VUL policies, this risk is generally offset by surrender charges that equal the difference between the cash account value and the cash surrender account value. Whole life carriers usually address lapse risk in a similar fashion through a lower credit rating to the policy's cash value account during the initial years of the whole life contract.

D. When Insurance May No Longer Make Sense in the Estate Plan. Although some estate planning attorneys and wealth advisors may not realize this, life insurance is not a "set it and forget" estate planning strategy. There is little in the high net worth and ultra-high net worth estate planning world that does not require some form of ongoing management, such as GRATs and installment sales to defective grantor trusts, and life insurance strategies are no exception. Accordingly, depending on the purpose of the insurance, the continued needs for insurance, the type of contract purchased, the ongoing costs of maintaining the insurance versus other investment

options and the value within the insurance contract (for UL and whole life insurance, but even for term contracts that have conversion options as discussed later), the decision of whether to maintain, surrender or sell the contract may arise. Independent of wealth and ability and willingness to continue to pay into an insurance contract, there is a point referred to as the "crossover point" where it does not make sense to continue to maintain coverage.[19]

"Crossover simply defined means how long the client must live before the insurance policy becomes a less favorable investment than its [investment] alternative."[20] Although IRRs through life expectancy under a contract may seem to be reasonable to the policyowner, the inquiry for the policyowner in determining whether to maintain the coverage should be to examine the range of returns from the universe of other investments available to the policyowner and to actually unpack the policy illustrations, including maximum expense charges, to arrive at realistic returns from continued investment in the contract through life expectancy, which for wealthy persons as discussed earlier may be significantly greater than the presumed life expectancy at the time the contract was placed. In some cases, continued investment in an insurance policy may result in the insured funding his or her own death benefit, or even worse, coming out of pocket if the insured lives beyond life expectancy.

As mentioned above, UL insurance carriers have demonstrated that they can and will increase costs of insurance, and, therefore, policy illustrations provided even as recent as one year prior may not be the same as those provided in the current year. The following is a policy illustration provided by Voya during February 2020:

[19] *See above* n.1 at 1, 12-14.
[20] *Id.* at 12.

Premiums are paid at the beginning of the year. The Accumulated Value, Cash Surrender Value and Net Death Benefit are shown as of the end of each policy year.

			GUARANTEED 4.50% Interest Rate Maximum Charges			NON-GUARANTEED ILLUSTRATED 4.50% Interest Rate Current Charges		
Yr	End of Yr Age	Premium Outlay	Accumulated Value	Cash Surrender Value	Net Death Benefit	Accumulated Value	Cash Surrender Value	Net Death Benefit
21	76	0.00	1,032,019	1,032,019	10,000,000	1,149,810	1,149,810	10,000,000
22	77	75,000.00	746,084	746,084	10,000,000	1,200,823	1,200,823	10,000,000
23	78	75,000.00	384,287	384,287	10,000,000	1,246,156	1,246,156	10,000,000
24	79	75,000.00	0	0	10,000,000	1,284,468	1,284,468	10,000,000
25	80	75,000.00	0	0	10,000,000	1,314,345	1,314,345	10,000,000
		300,000.00						
26	81	75,000.00	0	0	10,000,000	1,334,287	1,334,287	10,000,000
27	82	75,000.00	0	0	10,000,000	1,342,687	1,342,687	10,000,000
28	83	75,000.00	0	0	10,000,000	1,337,810	1,337,810	10,000,000
29	84	75,000.00	0	0	10,000,000	1,318,908	1,318,908	10,000,000
30	85	75,000.00	0	0	10,000,000	1,282,824	1,282,824	10,000,000
		675,000.00						
* 31	86	75,000.00	0	0	0	1,227,259	1,227,259	10,000,000
32	87	75,000.00	0	0	0	1,149,639	1,149,639	10,000,000
33	88	75,000.00	0	0	0	1,047,068	1,047,068	10,000,000
34	89	75,000.00	0	0	0	916,253	916,253	10,000,000
35	90	75,000.00	0	0	0	753,435	753,435	10,000,000
		1,050,000.00						
36	91	75,000.00	0	0	0	643,518	643,518	10,000,000
37	92	75,000.00	0	0	0	507,897	507,897	10,000,000
38	93	75,000.00	0	0	0	344,354	344,354	10,000,000
39	94	75,000.00	0	0	0	147,759	147,759	10,000,000
* 40	95	75,000.00	0	0	0	0	0	0
		1,425,000.00						

* Year 31, Month 1 (August 2029)
In the event that the guaranteed costs were deducted and the guaranteed interest rate was paid from 2/27/2020 forward, the policy would lapse and cannot be illustrated beyond the year shown. Additional premiums would be required to continue the coverage.

* Year 40, Month 9 (April 2039)
Based on current costs and the assumed interest rate illustrated, the policy would lapse unless additional premiums are paid.

Under the non-guaranteed illustration, the death benefit continues beyond age 85 through age 94. However, only one year later in May 2021, Voya would no longer provide a non-guaranteed illustration and only the following guaranteed illustration was provided:

Premiums are paid at the beginning of the year. The Accumulated Value, Cash Surrender Value and Net Death Benefit are shown as of the end of each policy year.

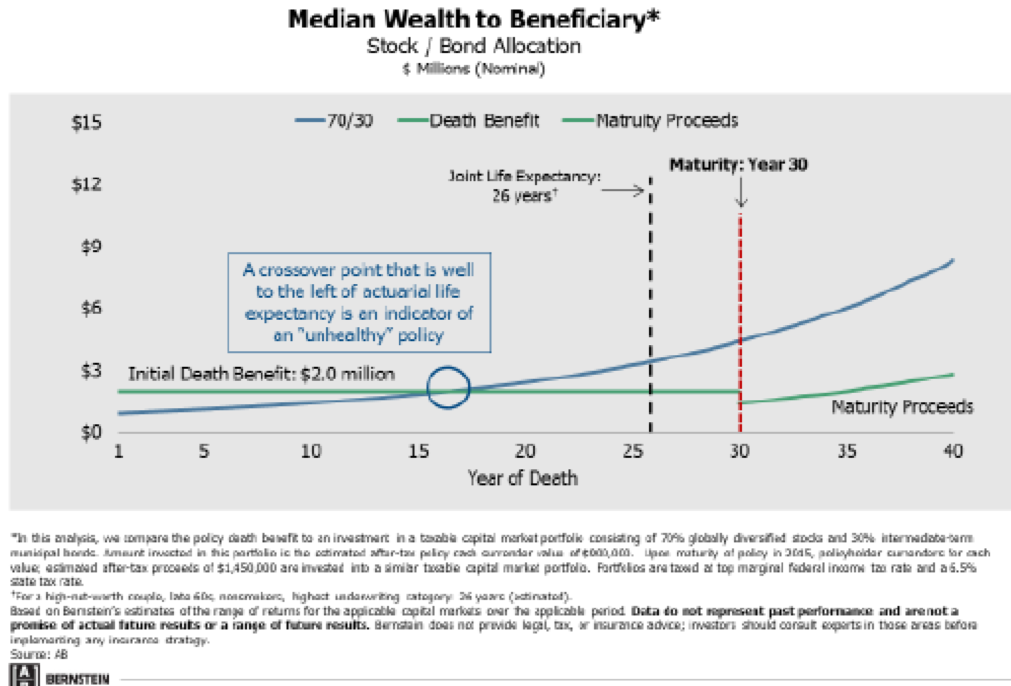
				GUARANTEED *4.50% Interest Rate* *Maximum Charges*		
	Yr	End of Yr Age	Premium Outlay	Accumulated Value	Cash Surrender Value	Net Death Benefit
	22	77	0.00	1,148,389	1,148,389	10,000,000
	23	78	75,000.00	823,299	823,299	10,000,000
	24	79	75,000.00	412,662	412,662	10,000,000
	25	80	75,000.00	0	0	10,000,000
			225,000.00			
	26	81	75,000.00	0	0	10,000,000
	27	82	75,000.00	0	0	10,000,000
	28	83	75,000.00	0	0	10,000,000
	29	84	75,000.00	0	0	10,000,000
	30	85	75,000.00	0	0	10,000,000
			600,000.00			
*	31	86	75,000.00	0	0	0
			675,000.00			

* Year 31, Month 1 (August 2029)
In the event that the guaranteed costs were deducted and the guaranteed interest rate was paid from 5/19/2021 forward, the policy would lapse and cannot be quoted beyond the year shown. Additional premiums would be required to continue the coverage.

With the assumed crediting rating and 2020 charges, the policy originally was scheduled to lapse in 2039, but assuming maximum charges under the policy, the policy would lapse at age 85, well before this client's life expectancy.

Pauloski and Bishop develop a crossover point analysis that they use at Bernstein to assist clients in confirming whether to continue coverage, and they refer to this as the "sick" and "healthy" policy analysis. The Voya policy illustrated above had become a "sick" policy with a 76% chance of lapse under the guaranteed illustration because the insured had a 76% chance of living beyond age 85, meaning continued investment at the current $75,000 a year premium in the contract was likely to consume all cash value in the contract (approximately $1.2 million) and yield zero death benefit. Pauloski and Andrew's sick policy analysis illustrated below illustrates the crossover point as the point in time when an alternative investment in the financial markets would yield a better

overall financial result to the beneficiary and assumes the cash surrender value is withdrawn and invested in the capital markets[21]:



However, Pauloski and Bishop do not in their analysis presume an amount in excess of the cash surrender value may be received if the policyowner decided to exit the contract. A life settlement of the policy, which is a sale of a life insurance contract in the secondary market discussed in the next section in greater detail, may yield greater proceeds to the policyowner than a surrender for cash value thereby increasing the financial benefit from exiting the insurance contract in favor of an alternative investment strategy. Because a life settlement will not be consummated if the amount received by the policyowner is not in excess of the cash surrender value, the life settlement,

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[21] *Id*. at 15.

if available, is necessarily greater than the cash surrender value, and studies have found that it is on average four times the amount of the cash surrender value under the contract.[22]

Identifying the crossover point requires the coordination between financial advisors, insurance advisors, estate planning attorneys and accountants to help identify when the client may be more well-advised to exit an insurance plan, and the life settlement market may provide an opportunity to receive significantly more than the cash surrender value for life insurance contracts that will not be maintained for any reason. Accordingly, the advisory team should seek to consult with a reputable life settlement broker to assist the client and the team with efficiently accessing the settlement market if the insured is age 70 or older or younger than age 70 with some type of health impairment.[23]

E. Strategies for Exiting a Life Insurance Contract That Will Not Be Maintained. Although estate planning attorneys may shudder to think that "permanent" insurance lapses without paying a death benefit or is surrendered for a fraction of the premiums paid in, it does so on a very regular basis[24], and all of the thoughtful planning and what may be years, upon years of gifts to ILITs for the payment of premiums, combined with marital partition agreements in Texas and other community property states and Crummey withdrawal notice letters, may have been done without any significant wealth transfer benefit for the client. During 2018, 92% of all life insurance policies

[22] Januario, Afonso V. and Narayan Y. Naik, "Empirical Investigation of Life Settlements: The Secondary Market for Life Insurance Policies," London Business School (June 10, 2013).

[23] *See* Huddleston, Cameron and Amy Danise, "Life Settlements Provide Escape Hatch When You Need Cash", Forbes Advisor, https://www.forbes.com/advisor/life-insurance/life-settlements/ (March 28, 2021) (stating that typically insureds must be 65 years or older for the policy to qualify for a settlement and the average age of people who sell policies through life settlements is age 75).

[24] *See* note 14 and discussion above of Olin Wharton Study that an estimated 88% of all universal life contracts never pay a death benefit and are either surrendered or lapse.

(by face amount) that terminated were lapsed or surrendered without paying a death benefit.[25] This is not the fault or responsibility of the estate planning attorney or insurance advisor but a function of changed circumstances—for example, (i) a significant liquidity event for the client, combined with meaningful wealth transfer, making the insurance no longer necessary, (ii) a decline in wealth where it is no longer practical or beneficial for the client or other policyowner to maintain the insurance, (iii) owning a universal life insurance policy that has underperformed or was intentionally underfunded and is now at that crossover point where continued investment in the contract may not yield the optimal financial result, or (iv) a plan to use the value of an existing insurance contract on the parent generation to purchase other assets to increase the wealth of the family, including insurance on younger generations that may be more affordable and provide coverage for estate and GST taxes due at their death. Premium fatigue and confusion are also very real in the insurance world—wealthy individuals become exhausted by the continued required funding of an insurance contract, and confused about the original purposes of the insurance acquired years prior, and sometimes they decide to cease paying into a contract.

But what if the client was advised that an insurance policy that was going to lapse or be surrendered could be sold to a sophisticated institutional investor within a short period of time, 60 days or less, thereby transforming the policy from an asset (or liability depending on the viewpoint) with no current value or continued purpose within the plan or with a value that was a fraction of the amount invested in the contract to an asset with a value that may be well in excess of the premiums paid and multiples of the cash surrender value? Historically, the owner of a life insurance policy that was no longer needed, desired or advisable, whether because the policy became unaffordable, the

[25] Long, Anne, "Being Healthy is No Longer an Obstacle to a Life Settlement," *The Street* *https://www.thestreet.com/retirement-daily/your-money/being-health-no-longer-obstacle-to-life-settlement* (Oct. 28, 2020) (citing American Council of Life Insurers Fact Book 2019 https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2019FLifeInsurersFactBook.ashx?la=en (2019)).

goals and objectives of the insured, family or other policyowner changed or the policy had reached that "crossover point", had two options: (1) to let the policy lapse or (2) surrender the policy to the insurance carrier for the policy's cash surrender value. If a policy lapses without paying a death benefit, the entire amount invested in the contract, along with any gift and GST exemption allocated to an ILIT holding the insurance policy, is wasted and the coverage terminates. For term insurance, this may be a calculated decision to allocate exemption, usually GST exemption combined with gifts within the annual exclusion amount (currently $15,000 per year per individual, or $30,000 per year with gift splitting with a spouse[26]), even though the term insurance may not be maintained because of the potential leverage of the GST exemption if the insured dies within the policy term. For permanent insurance, however, the client may allocate gift and GST tax exemptions because the policy was intended to be maintained through the insured's death. If the policy is surrendered for the cash surrender value, a portion of the amount invested in the contract can be recouped, but for most universal life contracts this amount is less than the premiums invested in the contract, and in the early years of the contract is significantly less due to the surrender charges described above.

However, if the policy should not, will not or cannot be maintained through life expectancy, there is a secondary market for existing life insurance policies that allows the policyowner to sell the policy to a third party for less than the expected death benefit but more than the policy's available cash surrender value. Such transactions are referred to as life settlements. The value of a particular life settlement depends on various factors, including the insured's life expectancy and the nature and terms of the policy.

[26] I.R.C. § 2503(b).

Fiduciaries of insurance trusts have a responsibility to be informed regarding the opportunity to exit an insurance contract on more favorable terms than a lapse or surrender through a life settlement. Texas trustees have fiduciary duties to their beneficiaries that include (i) the duty to act competently; (ii) the duty to reasonably exercise discretion; (iii) the duty of loyalty, and (iv) the duty to make a full disclosure of material facts.[27] For trustees of insurance trusts where the donor (often the insured) indicates an unwillingness to continue to make contributions to support premium payments, fiduciary liability can be avoided by working with the beneficiaries and the insured to consider other options for funding the policy, if it otherwise is advisable to maintain. If continued coverage is not advisable or desired, the trustee can work with the insured and the beneficiaries to sell the policy in a life settlement transaction that will yield an amount greater than the cash surrender value of the policy if it otherwise qualifies for a life settlement. The failure to inform the beneficiaries regarding a potential lapse of an insurance policy and seek alternatives to preserve value to the trust and its beneficiaries could subject the trustee to significant liability for breaches of fiduciary duties owed to the beneficiaries. Trustees, therefore, must be informed regarding options to avoid a policy lapse or a policy surrender that results in the trust receiving less than the amount that may be received in a life settlement transaction.

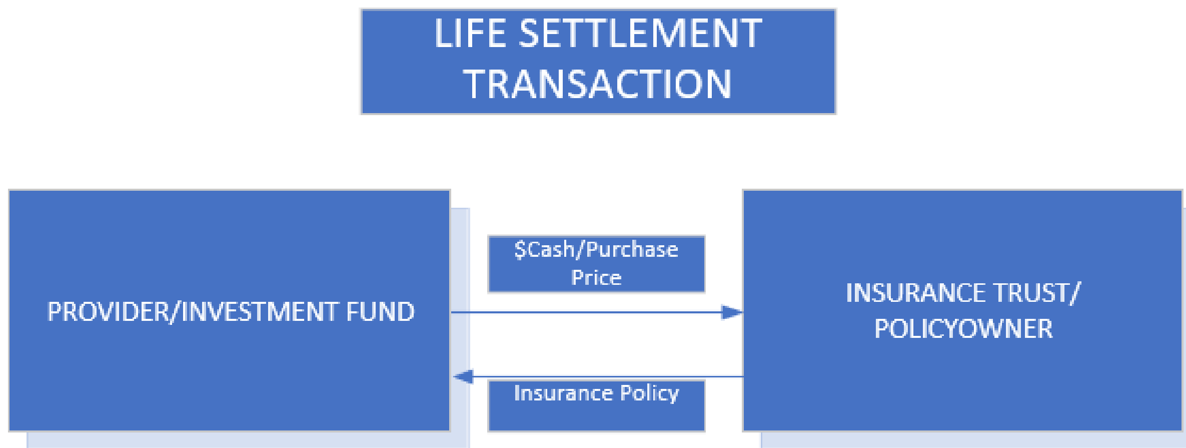
***CASE STUDY*:** Gus Guitar was a successful musician. His grandmother had died about 14 years prior, and his grandfather, who was now 94, had married a 20-year younger woman after his grandmother's passing. In recent years, Gus's grandfather had become estranged from Gus's uncle, Steve Shop, and Gus' mother, Greta Guitar, as a result of the influence of the grandfather's younger wife. Uncle Steve had for many years operated a successful commercial business with Gus's

[27] *See* Moore, Joyce W., Fiduciary Duties of Trustees and Estate Code Fiduciaries, 68 The Advoc. (Texas) 33 (Fall 2014).

grandfather, and only months prior was fired by his father at the behest of the younger wife. In 1990, Gus's grandfather and grandmother established an insurance trust and named Uncle Steve as trustee. Gus's mother, Greta, and Uncle Steve were the sole beneficiaries of the insurance trust which held $7.5 million in survivor universal life insurance. In May 2017, Uncle Steve allowed $4.5 million of the life insurance to lapse because Gus's grandfather refused to make gifts to pay the insurance premiums. The contract was not a guaranteed contract, and Gus's grandfather had outlived his life expectancy causing additional premiums to be required to maintain the coverage. Gus contacted his estate planning attorney in June of 2017 when Gus was asked by his grandfather to release all of Gus's interest in the insurance trust and some other trusts, none of which Gus had any information about. The estate planning attorney discovered that the $4.5 million of insurance had lapsed and the remaining $3 million of insurance was going to lapse in the near term if an additional $250,000 was not contributed to the trust to pay the premium due. The estate planning attorney called an insurance advisor who advised her and Gus that the remaining $3 million policy could be sold in a life settlement transaction. Uncle Steve and Gus's mother, Greta, decided to proceed with the sale of the policy and received $1.5 million from the life settlement. Although Gus's mother, Greta, could have sued Uncle Steve for breach of fiduciary duty for failing to become informed about the life settlement option to sell the $4.5 million of insurance that he allowed to lapse in May 2017, Gus's mother decide to not pursue litigation against her brother. Instead, they together pursued litigation against their father's younger wife after their father passed, and the funds from the life settlement provided them with the financial security to initially pay attorneys and to pursue this greater litigation.

1. <u>What are Life Settlements</u>? The origins of life settlements stem from the early years of the AIDS crisis when those sick with AIDS sold existing life insurance policies in order to receive

funds for end-of-life support and medications, and this transaction became known as a viatical settlement.[28] In a viatical settlement, the insured's health is impaired and there is an ascertainable limited life expectancy that is generally 24 months or less. I.R.C. § 101(g). Although business models vary, in a typical life settlement scenario, a policyowner (whether an individual, trust or entity owner) sells an existing policy to a life settlement provider that facilitates a simultaneous transfer of that policy to the purchaser, which is somewhat analogous to a title company in a real estate transaction but in this case the provider only represents the interests of a private investment fund or other investor purchasing the policy. That fund or other investor, in turn, receives the policy from the provider and holds the policy until maturity, pays the premiums, and collects the net death benefit. The following illustrates a typical life settlement transaction:



These purchasing funds or other investors may also bundle and sell policies purchased to other private investment funds or institutional investors in the tertiary market. Although the policyowner

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[28] Evans, Bruce D., David T. Russell and Thomas W. Sager, "Operational, Legal and Tax Issues in Life Settlement Transactions", *Journal of Insurance Regulation,* https://www.mccombs.utexas.edu/~/media/Files/MSB/Research/2014Q1/Operational%20legal%20and.pdf (2013) at 102.

may contact and offer to sell the policy to a life settlement provider directly, direct sales usually do not result in best pricing for the policyowner because the policyowner is generally uniformed regarding the potential value of the policy in the broader life settlement market. Considering the significant expertise required to properly understand, market and consummate sales of existing insurance contracts to life settlement providers, policyholders are well advised to initiate these transactions by contacting an experienced and qualified life settlement broker or by having their insurance agent, estate planning attorney, tax advisor and/or financial advisor to help them retain an experienced and qualified life settlement broker to assist them in the sale of their policy.

> The differential between the surrender … value of the policy and the present value of the policy in a life settlement transaction creates an arbitrage opportunity. By matching a willing policyholder with one or more investors, a settlement broker can engineer a transaction in which the parties benefit by splitting the differential among themselves. The … policyholder receives more in the life settlement than he or she could receive from surrender. … The settlement broker earns a fee for arranging the transaction. The terms of the split are subject to negotiation. Since there is no transparent organized market for settlements, the terms can vary across transactions. … Still, after investor discounts and broker fees, the negotiated payout to the policyholder is usually substantially more than the surrender value of the original policy.[29]

[29] *Id.* at 104-105.

The following illustrates an actual life settlement transaction with the assistance of an experienced life settlement advisor that implemented an auction process that includes contacting every provider licensed to purchase insurance in Florida where the policyowner trust was formed[30]:

	Provider 1	Provider 2	Provider 5	Provider 3	Provider 4	Bid IRR	Bid Increase
Bid 1	**$1,512,000**					15.24%	
Bid 2		**$2,200,000**				11.17%	$ 688,000
Bid 3				**$2,300,000**		10.73%	$ 100,000
Bid 4	**$2,400,000**					10.31%	$ 100,000
Bid 5					**$2,600,000**	9.53%	$ 200,000
Bid 6			**$2,625,000**			9.44%	$ 25,000
Bid 7		**$2,700,000**				9.18%	$ 75,000
Bid 8	**$2,725,000**					9.09%	$ 25,000
Bid 9			**$2,750,000**			9.00%	$ 25,000
Bid 10	**$2,775,000**					8.92%	$ 25,000
Bid 11		**$2,850,000**				8.67%	$ 75,000
Bid 12			**$2,875,000**			8.59%	$ 25,000
Bid 13	**$2,885,000**					8.56%	$ 10,000
Bid 14		**$2,913,000**				8.47%	$ 28,000
Bid 15	**$3,015,000**					8.15%	$ 102,000

Had the policyowner reached out to only one direct purchaser, one can assume the first offer may have been the only offer, and since this amount was around $300,000 more than the policy's cash surrender value, the policyowner may have thought this was a fair price not realizing the actual value of the policy is over *two times* the cash surrender value. The introduction of competition in this situation doubled the initial offer price from $1.5 million to $3 million—and notice that the initial offer price was from the same provider who ultimately purchased the policy.

Although life insurance companies could effectively eliminate the life settlement market by "repricing their surrender values to their actuarily fair amounts," they have failed to do so.[31] Accordingly, the life settlement opportunity will continue to persist while life settlements

[30] Source Treyled Life Settlements LLC actual 2021 auction results.
[31] *Id.* at 106.

transactions are limited in numbers. An estimated 500,000 insurance policies that may qualify for a life settlement lapse annually; however, in 2020 only 3,241 policies were sold in a life settlement transaction.[32] This shocking differential is only explained because of one problem—the pure lack of knowledge among insureds and their advisors regarding the life settlement market. The foregoing is an information gap that each reader of this paper can readily solve by talking to their clients and partner advisors regarding life settlements and finding a knowledgeable partner in the life settlement space who can assist their clients with efficiently accessing the life settlement market should they wish to exit an existing life insurance contract.

2. Development of Life Settlement Market and Differentiating the Current Opportunity from Historical Life Settlements. For many insurance and financial advisors, life settlements may have seemed taboo largely because of fears of insurance carrier backlash[33], prior lack of regulation or a sordid past beginning with the AIDS epidemic, but a life settlement should be considered as a viable option when conducting a policy audit and review. With (i) tax law changes clarifying that a seller's cost basis in a life insurance policy is the aggregate premiums paid without reduction for costs of insurance, (ii) significant increases in the lifetime estate and gift tax exemptions, (iii) increased competition in the settlement marketplace, (iv) regulations in 43 of the 50 United States, and (v) the increased risk of cost of insurance expense charges by carriers life settlements are as seller friendly as they have ever been.[34] I.R.C. § 1016(a). Private investment and institutional funds are investing in the purchase of life insurance policies to achieve uncorrelated returns as

[32] Magna Life Settlements Industry Report (2018) at 30 (citing research from the Insurance Studies Institute); Horowitz, Donna, "Covid Little Obstacle to Settlement Market Last Year," *The Deal* (May 20, 2021) at 6.
[33] Numerous large carriers forbid their agents to even discuss life settlements because the insurance company is not the winner in in the life settlement transaction. In the absence of the life settlement, most policyowners would either surrender their policies for the cash value or allow their policies to lapse.
[34] *See* McGonnell, Shane, "Why Life Settlements are Becoming a Mainstream Financial Option", *Forbes Finance Council* (May 7, 2021).

compared with traditional asset classes. Greater industry competition among a wider purchaser field, together with a prolonged low interest rate environment, has driven private and institutional investors to pay more for attractive policies, thereby raising the overall value of life insurance policies in the secondary life settlement marketplace, particularly for larger contracts with top-rated carriers.

3. Policies That Qualify for a Life Settlement. Individual and second-to-die universal life, indexed universal life, variable universal life, and convertible term life insurance policies typically qualify for life settlements, and approximately 95% of all policies sold in a life settlement transaction are universal life insurance policies. The age and the health of the insured will dictate whether there is an interested purchaser, and insureds in a life settlement transaction typically have a life expectancy of 15 years or less. Accordingly, as mentioned above, the age of the insureds in a life settlement transaction is usually over age 70 or younger with some type of health impairment.

4. Regulation and Income Tax Treatment of Life Settlements. Life settlements are authorized transactions nationwide and are regulated for consumer protection in almost every state within the United States. Most regulated states enforce a waiting period before the policyholder can sell a contract, though there may be exemptions available under certain circumstances such as illness, divorce, retirement, or disability. These states also typically require state regulator-approved contracts, escrow agreements, and disclosures to be used for the life settlement process. The life settlement regulations and requisite approval process are intended to ensure transparency and protect policyholders from fraud. *See* Exhibit A for an overview of Life Settlement Regulation in the United States.

a. Tax Treatment of Traditional Life Settlements (Non-Viatical). As discussed above, the tax treatment of life insurance during the contract and upon payment of the death benefit is

very favorable to policyholders and their beneficiaries. For permanent insurance designed to build up cash and/or investment value, investment savings grow without income tax consequences. I.R.C. § 7702(g). If the policyowner chooses to hold the policy until the insured's death, no income taxes are incurred on the receipt by the beneficiary of the difference between the cumulative premium payments and the amount of the death benefit. Life insurance gains only become taxable when the policyholder benefits from them during his or her lifetime. The foregoing happens when the policyholder receives more cash than was paid in total premiums, such as in a surrender or a life settlement of a policy.[35]

Although there has been some confusion regarding whether life insurance is ordinary income or capital gain property, a life insurance policy should be considered a capital asset described in I.R.C. § 1221 when sold in the life settlement transaction, which is a different result from when a life insurance contract is surrendered. When surrendered, the amount received by the policyowner will be treated as ordinary income under I.R.C. § 72(e) to the extent that amount exceeds the policyowner's "investment in the contract."[36] Since income received in excess of premiums paid, less amounts received under the contract, is ordinary income under I.R.C. § 72(e), life insurance is often considered to be ordinary income property. However, the treatment of a surrender as generating ordinary income only arises because, although a life insurance policy is a capital asset, there is no sale or exchange to support capital gain treatment in a policy surrender.

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[35] *See* Rev. Rul. 2009-13 and Rev. Rul. 2020-5 (modifying Rev. Rul. 2009-13); *see also* I.R.C. §1016(a).

[36] I.R.C. § 72(e)(2)(B) provides that any amount "received before the annuity starting date (i) shall be included in gross income to the extent allocable to income on the contract, and (ii) shall not be included in gross income to the extent allocable to the investment in the contract." I.R.C. § 72(e)(6) provides a definition of “investment in the contract", which is "(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws."

In Revenue Ruling 2009-13 the Service examines the sale of a life insurance policy to an unrelated person who would suffer no economic loss upon the insured's death, essentially a life settlement transaction. In that ruling, the Service determined that the inside build-up of cash value in excess of basis under the life insurance contract immediately prior to the sale was ordinary income that must be recognized as such under the "substitute for ordinary income" doctrine, but the balance of the purchase price received would be long-term capital gain.[37] The Service reasons in the ruling:

> The Supreme Court has held, under the so-called "substitute for ordinary income" doctrine, that "property" within the meaning of §1221 does not include claims or rights to ordinary income. Instead, the Court "has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income." *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n.5 (1988) (noting that the "substitute for ordinary income" doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. See also *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d

[37] Rev. Rul. 2009-13.

1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the "substitute for ordinary income" doctrine after the *Arkansas Best* decision). …

Application of the “substitute for ordinary income” doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the "inside build-up" under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See, e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960). Rev. Rul. 2009-13, *Situation 2*.

The Service concludes in Revenue Ruling 2009-13 that the inside build-up under the seller's life insurance contract immediately prior to the sale to the buyer is ordinary income under the "substitute for ordinary income" doctrine, but because the seller's life insurance contract was not property described in I.R.C. § 1221(a)(1)-(8) and was held by the seller for more than one year, the remaining amount received in the sale transaction is long-term capital gain within the meaning of I.R.C. § 1222(3). I.R.C. § 1016(a) and Revenue Ruling 2020-5 confirm that the seller's cost basis in a life insurance policy is not reduced by the cost of insurance and equals premiums paid less amounts received under the contract.

***CASE STUDY*:** Jerry Jeweler no longer required his $15 million of life insurance coverage initially purchased to insure his valuable jewelry business (which he since transferred to his children in trusts through other estate planning), and the cost of the policy premiums were increasing significantly. The policy was trust owned. The trustee saw a television ad from a national life settlement provider and called the provider directly with the intention of negotiating a maximum purchase price offer. After approximately one month of direct negotiations with that

life settlement provider, the trustee received a maximum offer of $1,850,000 from the life settlement provider. Prior to entering into the life settlement transaction, the policyowner was referred to a reputable life settlement broker for a second valuation opinion on the policy purchase price. The broker was then engaged to represent the trustee as the policy seller. The opening offer received by the broker was $2,700,000 – nearly $1,000,000 more than the offer previously received directly from the life settlement provider. The following illustrates the ultimate sale of Jerry's policy for $5.58 million and the income tax consequences to the trust, which as a grantor trust resulted in Jerry paying the income taxes from assets outside of the trust and a $1.2 million benefit to his children as beneficiaries of the life insurance trust:[38]

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[38] Assets held in intentionally defective grantor trusts are property of the trust for gift tax purposes, but the income on such property is attributable to the grantor for income tax purposes. The foregoing allows the grantor to continue to have the income tax liability associated with the trust income without causing the property to be includible in the grantor's estate at death. The grantor trust technique is most commonly used to shift wealth to the beneficiaries of the trust by allowing the grantor to pay the income taxes on income earned in the trust which essentially allows the grantor to make gift tax free contributions of the tax liability by paying this directly. It also allows the grantor to engage in transactions with the trust that are disregarded for federal income tax purposes, such as sales of appreciated assets. *See generally* I.R.C. §§ 671-679; Rev. Rul. 85-13 (ruling that the grantor trust is not a separate taxpayer capable of engaging in sales transactions with the grantor and declining to follow *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).

Income Tax Case Study	
Jerry Age 80	
Death Benefit	$ 15,000,000
Direct Purchase Initial Offer (Pre-Tax/Comission Inclusive)	$ 1,850,000
Net Amount to Policyowner from Auction Before Taxes	$ 5,580,100
Premiums Paid/Basis In Policy	$ 612,000
Cash Surrender Value	$ 546,000
Gain on Sale	$ 4,968,100
Capital Gains Tax Due (23.8%)	$ 1,182,408
Net Amount to Policyowner After Commission and Taxes	$ 4,397,692
Direct Purchase Offer (After-Tax/Commission Inclusive)	$ 1,555,356
Difference Auction and Direct Purchase (After-Tax and Commission)	$ 2,842,336

The foregoing Case Study illustrates (i) the significant additional value to the trust from a life settlement versus a surrender of the policy, and (ii) the potential loss of value avoided by working a reputable life settlement broker instead of accepting the initial offer provided by the direct purchase provider.

b. Tax Treatment of Viatical Settlements. The sale of an insurance policy on the life of an insured who is terminally ill to a viatical settlement provider will not be taxable, and the entire amount received will be excluded from income to the seller as amounts paid by reason of the death of the insured.[39] An insured who is terminally ill or sometimes referred to as "viatical" is defined as one "who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death within 24 months of the date of certification."[40] A viatical settlement provider is defined in I.R.C. § 101(g)(2)(B) as any person who regularly buys

[39] I.R.C. § 101(g).
[40] I.R.C. § 101(g)(4)(A).

or receives assignments of insurance policies on the lives of terminally or chronically ill insureds and who is either licensed for that purpose by the state in which the insured resides or, if state law does not require such licensing, satisfies other requirements.

5. Trust Owned Life Insurance ("TOLI"). Trustees have fiduciary duties to their beneficiaries that include (i) the duty to act competently; (ii) the duty to reasonably exercise discretion; (iii) the duty of loyalty, and (iv) the duty to make a full disclosure of material facts.[41] As discussed above, life insurance is not a buy and hold or a "set it and forget it" investment strategy but is an asset that requires ongoing management. Fiduciaries of insurance trusts have a duty to monitor and manage the policies held in trust, and in connection with the exercise of this duty should obtain regular policy statements and illustrations and coordinate annual performance reviews or audits with the assistance of an insurance professional to determine (i) whether the policy is performing in a manner consistent with the illustrations, and (ii) the insured's age when the policy is projected to lapse.

It is estimated that 90% of trustees of ILITs do not have any specialized knowledge or skill to manage life insurance.[42] Further, most trustees fail to undertake regular policy audits or even complete the simple tasks associated with holding life insurance in trust, such as issuing the Crummey notice letters when contributions are made for premium payments. The combination of the foregoing makes TOLI vulnerable to lapse. *See e.g.*, *Rafert v. Meyer*, 209 Neb. 219 (Feb. 27, 2015) (finding that the trustee had a statutory duty under Nebraska law "to keep the qualified beneficiaries of the trust reasonably informed … of the material facts necessary for them to protect

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[41] For a discussion of these fiduciary duties under Texas law, see Moore, Joyce W., Fiduciary Duties of Trustees and Estate Code Fiduciaries, 68 The Advoc. (Texas) 33 (Fall 2014).

[42] *See* Shenkman, Martin M., Henry Montag and Richard Weber, Trust Owned Life Insurance (TOLI) What Practitioners Need to Know (2017) https://shenkmanlaw.com/blog/2017/03/17/trust-owned-life-insurance-toli-issues/.

their interests," and the failure to receive premium notices and provide information to the beneficiaries regarding the required premiums was a direct and proximate cause of the damages. The trustee was found to have liability even though the trust agreement provided that the trustee had no obligation to pay premiums or make sure they were paid by the grantor.) In connection with keeping beneficiaries reasonably informed about the status of an insurance policy held in trust, trustees annually should obtain, share and verify in force illustrations. If current policy projections and funding levels will not maintain the policy, trustees should seek professional advice regarding options for preserving value in the insurance contract.[43]

For trustees of insurance trusts where the donor (often the insured) indicates an unwillingness to continue to make contributions to support premium payments, fiduciary liability, as pointed out above, may not be avoided by relying on exculpatory clauses in the trust agreement that the trustee has no responsibility to pay premiums or arrange for gifts to the trust from the grantor to enable premiums to be paid. However, liability can be avoided by obtaining in force illustrations and working with the beneficiaries, the insured and their professional advisors to consider other options for funding the policy, if it otherwise is advisable to maintain. If continued coverage is not advisable or desired, the trustee can work with the insured and the beneficiaries to sell the policy in a life settlement transaction that will yield an amount greater than the cash surrender value if the policy otherwise qualifies for a life settlement.

To assist clients and their fiduciaries in understanding the life settlement option for exiting a life insurance contract, estate planning attorneys should consider including information about life

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[43] *See* Shenkman, Martin M., Henry Montag and Richard Weber, Trust Owned Life Insurance (TOLI) What Practitioners Need to Know (November 17, 2017) https://shenkmanlaw.com/?search_webinars_only=true&s=toli&searchType=webinars.

settlements in client memoranda and specifically authorizing trustees to sell insurance policies in a life settlement transaction in the insurance powers section of their life insurance trust agreements.

6. Charitable Life Settlement Opportunity. A donor age 70 or older (or younger if there are health impairments) who has life insurance that will not be maintained, for any reason, may consider a current gift of life insurance to a public charity, including a donor advised fund, combined with a life settlement in lieu of allowing the policy to lapse or surrendering the policy for the cash surrender value. There may be options for using life insurance trust owned insurance as well, depending on the trust structure.[44]

The donor should be entitled to an income tax charitable deduction equal to the fair market value of the policy, and it would be reasonable to conclude that the fair market value of a policy sold in a life settlement transaction that occurred near in time to the gift of the policy to the charitable donee would be the gross amount paid in the life settlement transaction without reduction for any brokerage commissions paid.[45] Pursuant to Rev. Rul. 2009-13, the principles of Treas. Reg. § 1.170A-4(b)(1) would seem to also apply to a charitable donation of a permanent

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[44] A grantor trust that allows for the substitution of assets generally would allow the grantor to swap out an existing insurance policy held in trust with assets of equivalent value, followed by a donation to charity of the policy and life settlement by the charity. See I.R.C. § 675(c)(4); Rev. Rul 2011-28 (grantor's retention of power to substitute other assets of equivalent value for insurance policy held in trust does not cause value of policy to be includible in grantor's gross estate).

[45] Under current law, a qualified appraiser issuing a qualified appraisal of a policy gifted to a charity should be able to prepare such appraisal based on the willing buyer/willing seller standard of Treas. Reg. § 2512-1, provided by an actual life settlement transaction for the policy, rather than the interpolated terminal reserve value under Treas. Reg. § 2512-6. In addition, the value should be the gross amount paid by the purchaser similar to the valuation of assets for estate and gift tax purposes that do not reflect the costs of sale even though the amount received is net of these charges. *See* Treas. Reg. § 20.2031-1(b) and § 25.2512-1; *see also Estate of Smith v. Comm'r*, 57 T.C. 650, 658-659 (1972), aff'd, 510 F.2d 479 (2d Cir. 1975) (the Tax Court citing *Publicker v. Comm'r*, 206 F.2d 250 (3d Cir. 1953), explained "[t]he measure of value…is what could be received on, not what is retained from, a hypothetical sale."); *Estate of Scull v. Comm'r*, T.C. Memo 1994-211; Tech. Adv. Mem. 9235005 (IRS included the buyer's premium in the fair market value of artwork included in the decedent's gross estate and sold at public auction).

life insurance policy with a cash value, treating the donor's deduction as the fair market value of the policy, reduced by the ordinary income portion of the sale price.

The life settlement transaction may occur before or after the donation; however, since the full fair market value charitable deduction should be available, the income tax benefit from the contribution is likely greater if the policy is sold shortly after the gift to charity is completed. The donation must be reported on IRS Form 8283, Noncash Charitable Contributions, and a qualified appraisal obtained. The appraisal should be obtained following the life settlement which should establish the fair market value. The donor and donee charity should not be bound to the life settlement transaction at the time of the gift of the policy to avoid the income on the sale of the policy being taxable to the donor.[46]

Charities already owning insurance can also consider a settlement to accelerate receipt of funds for charitable purposes and avoid additional premium contributions that may not be provided by the insured/donor or advisable.

7. Accessing the Life Settlement Market. This author cannot underscore enough the importance of working with a knowledgeable and reputable life settlement broker that markets policies in a fashion designed to access all providers licensed to purchase policies in the state where the policyowner resides or state of trust formation for trust owned insurance. In addition, advisers should choose to work with a single life settlement broker and not make the mistake of marketing a policy through multiple brokers because of their desire to have maximum exposure to the universe of purchasers.

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[46] *See Dickinson v. Comm'r*, T.C. Memo. 2020-128 (2020) (In reliance on *Humacid v. Comm'r*, 42 T.C. 894 (1964), the Tax Court stated that "we respect the form of this kind of transaction if the donor (1) gives the property away absolutely and parts with the title thereto and (2) before the property gives rise to income by way of a sale," which the court referred to as the two prongs required to be met under *Humacid*.)

> Most reputable brokers shop cases to many of the same buyers. If multiple brokers submit the same case to a funding source, they dilute the market efficiencies and create a lack of interest from potential buyers. Many buyers will simply decline or ignore these cases because no particular broker is in control. In addition, one broker may hurt the potential bids of another by not sending the lowest combination of life expectancies, basically polluting the file.[47]

Commissions on life settlement transactions can be significant and there is a range of commissions charged. Some brokers charge a flat fee or a fee based on a percentage of the death benefit paid which does not seem to make sense or be advisable for the seller since this fee structure does not provide incentive for the life settlement broker to work on behalf of the seller to maximize the amount received in the settlement transaction as the broker's compensation is not tied to that amount. In addition, the proceeds from the sale transaction are usually significantly less than the death benefit unless the insured is expected to die in the near term, so charging a fee based on the death benefit does not seem reasonable. Other combined broker and agent fees for life settlements can equal up to 30% or 35% of the gross proceeds paid. However, there are some experienced life settlement brokers looking to disintermediate the settlement market with a lower fee structure.

F. Concluding Thoughts. I regularly use insurance in my estate planning practice and am a huge proponent of life insurance that is (i) thoughtfully purchased with the advice of an experienced advisory team, including the attorney, insurance advisor, financial advisor and accountant, and (ii) placed in a well-structured life insurance trust. Life insurance solves for a

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[47] Gavartin, Amy, "Life Settlements", *The Tax Adviser* (January 31, 2010) https://www.thetaxadviser.com/issues/2010/feb/lifesettlements.html.

myriad of complex estate planning issues in what is normally thought to be a straightforward manner and understood cost. Life insurance can provide for income replacement and additional liquidity at the death of an earning spouse and estate tax replacement and liquidity for high net worth and ultra-high net worth clients.

Estate planning with life insurance provides for a hedge against an early death before other more complex transfer tax techniques have been implemented and matured. However, life insurance is *not* simple or straightforward, and insurance agents unfortunately are incentivized through front-loaded commissions paid by carriers to sell complex products that they may not fully understand themselves and may not effectively solve for the actual client need. Many life insurance policies become orphaned, and often clients cannot remember why the coverage was acquired or even the name of the selling agent.

The Conning 2018 Life Settlements Study confirmed that $200 billion worth of life insurance is allowed to lapse or is surrendered annually that could have qualified for a life settlement; however, the annual life settlement purchase proceeds during 2018 was only around $2.6 billion. The foregoing further demonstrates the disconnect discussed in the paper between willing and sophisticated institutional investors seeking to purchase insurance contracts and the insurance policy owners and their advisors who remain largely uninformed about opportunity to exit a life insurance contract with more favorable results than a surrender or lapse through the life settlement market.

Not every life insurance policy is a candidate for a life settlement, but if there is a determination made by the client and the advisory team that there is a "sick" policy and that continuing to maintain the policy is no longer advisable, or if the policy is otherwise not desired by the client for any reason including sale of an illiquid asset, successful wealth transfer by other means, premium

fatigue or changed personal circumstances, a life settlement should be considered. In addition, to avoid fiduciary liability and properly exercise fiduciary duties owed to the beneficiaries of life insurance trusts, it is the responsibility of trustees of life insurance trusts to become informed regarding life settlements which are no longer an unknown opportunity with questionable capital, but are sophisticated alternative investments fueled by multi-billion experienced Wall Street investment firms that yield greater returns to the policyowner than a policy lapse or surrender. In order to efficiently access the life settlement market, a knowledgeable settlement broker should be contacted because an efficient auction process will yield better pricing than a direct sale to a provider. By becoming more informed regarding a client's life insurance policies as the contracts mature, not just at the front-end when the coverage is placed and the insurance trust is established, estate planning attorneys and other client advisors can help clients avoid lapses and policy surrenders and rescue value that would otherwise be lost.[48]

[48] *See* Exhibit C for Sample Life Insurance Discussion Summary for Advisors.

<u>**EXHIBIT A**</u>

SUMMARY OF US LIFE SETTLEMENT REGULATIONS

Life Settlement Regulation

Forty-three states and the territory of Puerto Rico regulate life settlements, affording approximately 90% of the United States population protection under comprehensive life settlement laws and regulations.

Thirty of the regulated states have a statutorily mandated two-year waiting period before one can sell their life insurance policy, while 11 states have five-year waiting periods and one state, Minnesota, has a four-year waiting period. Most states have provisions within their life settlement acts whereby one can sell their policy before the waiting period if they meet certain criteria (i.e. owner/insured is terminally or chronically ill, divorce, retirement, physical or mental disability, etc.). Twenty of those states follow or very closely follow the National Conference of Insurance Legislators (NCOIL) Life Settlement Model Act, representing almost 53% of the U.S. population. Conversely, 12 states (roughly 12%) have passed a hybrid of the National Association of Insurance Commissioners (NAIC) Viatical Settlements Model and the NCOIL Model, or some variation thereof, or the pure NAIC Viatical Settlements Model Act.

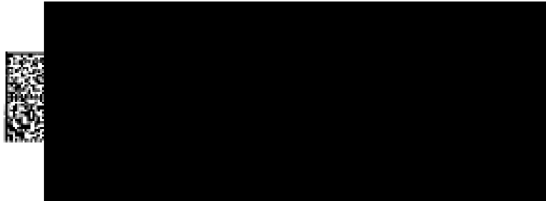
Michigan and New Mexico regulate viatical settlements only, while Alabama, Missouri, South Carolina, South Dakota, Wyoming, and Washington, D.C. do not regulate viatical nor life settlements. Most unregulated states and states that regulate viaticals only, with the exception of Missouri, who has a one-year contestability period, have a two-year contestability period under their general insurance code.

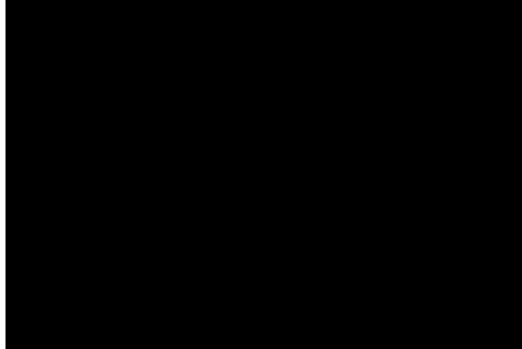
Source www.lisa.org/regulations-overview/

EXHIBIT B

LETTER RECEIVED FROM PRUDENTIAL ON PREMIUM REQUIRED TO MAINTAIN POLICY THAT WAS LESS THAN AMOUNT REQUIRED TO MAINTIAN GUARANTEED COVERAGE

Customer Service Office
PO Box 7390
Philadelphia, PA 19176
Phone: (800) 778-9837, Ext.2792





**Important Notice:
Your Policy Is in Default**

Dear Sir/Madam:

The life insurance policy listed above went into default on May 5, 2021. This means your Contract Fund contains less than the amount needed to keep your insurance coverage in effect.

To prevent your policy from ending without value, we must receive a payment in the amount of $ 7,677.17 before the grace period ends on July 6, 2021.

For your convenience, we have included a payment coupon with this letter. Please mail your payment together with the coupon in the enclosed reply envelope.

If you prefer to make your payment using our website, log in at www.prudential.com/login and then select "Make Payment." If you have not yet activated your online account access, you can do so by going to the aforementioned log-in page and then selecting "Register Now" on the right-hand side of the page. You can also make the payment by calling us at the number above. Online and phone payments must be submitted no later than 4:00 p.m. Eastern time on the due date. If the due date falls on a weekend or holiday, the payment must be submitted no later than the business day before the due date and prior to 4:00 p.m. Eastern time.

We value your business and look forward to hearing from you soon.

Sincerely,

Kimberly King

Kimberly King
Vice President, Operations

Enclosure

Life insurance is issued by The Prudential Insurance Company of America, Pruco Life Insurance Company (except in NY and/or NJ), or Pruco Life Insurance Company of New Jersey (in NY and/or NJ). All are Prudential Financial Companies.

Sample Life Insurance Discussion Summary for Advisors*

All advisors should become informed regarding their clients' life insurance. At each client intake or at the next client meeting for existing clients, advisors should ask about life insurance.

1. Does the client have life insurance?
    a. If no, is there a need for life insurance or has the client ever considered purchasing life insurance?
    b. If yes, is the insurance held in a life insurance trust or outright?
        i. If in trust, does the trust meet the client's current goals and objectives and is the trust being properly managed? If not, there may be an opportunity to transfer the insurance to another trust or do further planning with the insurance. These options should be further explored with experts at the firm or outside.
2. What are the policy terms—annual premiums, death benefit and is it term insurance or permanent insurance (universal life or whole life)?
    a. If universal life insurance, is it a guaranteed contract or an indexed or variable policy?
    b. The advisor does not need to be an insurance expert but can become informed regarding the basic differences in common life insurance products.
3. Does the client have a current policy illustration?
    a. If so, ask the client to share it with you or introduce you to the insurance advisor to obtain a current in force illustration.
4. What is the purpose of the life insurance?
    a. This is a key question because often clients no longer need life insurance purchased long ago but because they are wealthy, continue to pay premiums even if continued investment in the contract no longer yields an optimal financial result.
5. If the client is over age 70 (or under age 70 with some health impairment) it may be possible to sell existing life insurance (including trust owned insurance) to institutional investors and receive significantly more than the cash surrender value offered by the insurance company. This investor marketplace is the life settlement market. Term insurance that can be converted to permanent coverage may also be able to be sold.
6. What are life settlements?
    a. A life settlement is the transfer of a life insurance policy to a third-party investor for cash. At the close of the transaction, the investor/purchaser owns the policy and all rights to the death benefit and pays all future premium payments.
    b. The policyholder receives a lump sum payment that can be used for any purpose.
    c. The value of a particular life settlement depends on various factors, including the insured's life expectancy and the nature and terms of the policy.
7. After the initial meeting during which life insurance is discussed and the appropriate follow up, the advisor should coordinate with the client's insurance advisor to obtain annual in force illustrations and assist with policy audits for all coverage that may lapse prior to life

expectancy (which if there is no impairment is generally around age 90 for wealthy clients, men and women—that means a 50% chance of living beyond age 90).

8. Advisors can assist with providing a financial analysis of continued investment in the insurance policy versus the alternatives which should include a life settlement and reinvestment of the life settlement proceeds for any policy that qualifies for a life settlement.
    a. Other alternatives include a reduced death benefit or a policy surrender, but if the policy qualifies for a life settlement, the life settlement should yield a greater amount.

Discussions with clients regarding life insurance can lead to other opportunities with the client, and if there is a life settlement opportunity, the advisor may bring a valued solution to a problem which builds on the existing trust in the advisor and the firm. A life settlement can prevent loss to the client from a policy lapse or surrender for less than the amount that could be received in a life settlement transaction. Funds received in a settlement may increase assets under management and avoid sales of assets in the client's portfolio triggering gains and reducing the amount available for current investment or use by the client. A life settlement can transform insurance perceived by the client as negative or a bad investment into a positive financial result.

The advisor should understand the client's entire financial situation and explain to the client that life insurance is an asset, just like a stock or bond, that can be sold. 88% of all universal life insurance policies never pay a death benefit—they lapse or are surrendered. The advisor can provide a far better solution with a significantly improved financial outcome to the client by becoming informed regarding the client's life insurance and considering the opportunities that may be available to sell existing insurance in the life settlement market.

* This is a general summary designed for estate planning attorneys, financial advisors, corporate fiduciaries and accountants and can also inform the life settlement discussion for life insurance advisors.