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What the Professional Needs to Know About the Living Benefits of a Life Insurance Policy

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While everyone is well aware of and can provide several examples of the many uses of the ''death benefits'' of a life insurance policy, the same cannot be said of the various ''living benefits'' of a life insurance policy. The major reason people buy life insurance is so that when they die, their family, business partners, or other beneficiaries will receive a check from the insurer. Most are also aware that the proceeds from a life insurance policy can be received income-and estate-tax free, if set up properly.

Unfortunately, most people view life insurance as a stodgy document that you buy and put in a file drawer, only to be looked at when the insured passes away. That thinking worked up to the early 1980s when there were only two types of life insurance — term and whole life — which were both guaranteed. However, in the early 1980s, when E.F. Hutton created the first non-guaranteed Universal Life Insurance policy, everything changed.

This article will focus on the fact that life insurance when thought of as an ''asset class'' can, in addition to providing a death benefit for beneficiaries, also provide significant living benefits for the insured/owner.

LIVING BENEFITS THAT FEW KNOW ABOUT

There are four specific types of living benefits that can be enjoyed by those aware of and able to take advantage of them. However, as a practitioner with 35+ years' experience I speak with personal knowledge when I say that only a small number of policy owners and their advisors are aware of and understand many of the current living benefits available in a life insurance policy, capable of providing so much more than just a death benefit.

They are as follows:

1. The ability to withdraw funds from the death benefit of a life insurance policy to pay for qualified long-term care costs on a tax-free basis.

2. The ability to establish a tax-free exchange of cash value from a life insurance policy or an annuity to pay for long-term care costs or for a long-term care insurance premium.

3. The ability to accumulate cash value tax deferred and then distribute those assets and their gains tax free to supplement retirement funds at any point in the future.

4. The ability to sell a life insurance policy using a life settlement strategy to turn a premium bill into a significantly higher payout than an insurance company would pay.

Long-Term Care/Life Insurance Combination Policies

The Pension Protection Act of 2006 (PPA), which first became effective in 2010, marked a change in public policy on paying for long-term care. Since the largest financial burden for long-term care costs falls on state and federal governments, via Medicaid, many governmental officials were seeking ways to increase

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the public's use of private long-term care insurance, which had stalled out at a dismal 9–10% of market penetration. They were hoping to provide sufficient incentives for the general public to purchase private insurance themselves, rather than seek the counsel of an elder law attorney to help a client shelter their own funds while artificially impoverishing themselves and going on the Medicaid rolls. So, in the early 2000s a joint effort was made between the insurers and the federal and state governments that this would be accomplished by the creation of several new and significant tax benefits for those who purchase a PPA-eligible hybrid, combo, or linked life insurance, or annuity policy.

One of the most significant changes resulting from the 2006 PPA was the ability for a combo/linked life insurance policy to pay for qualified long-term care expenses directly from the death benefit of their life insurance policy, tax free. In addition, it allowed for the tax-free purchase of a long-term care insurance policy from the otherwise taxable gains of a life insurance policy's cash value, or a single premium deferred annuity (SPDA).

The PPA also introduced a new crop of products that created significant leverage in creating a long-term care benefit that can create a dollar value three to five times greater than the initial lump-sum deposited into one of these new asset classes of policies. These policies are referred to as asset-based, combination, linked benefit, or hybrid policies. In addition to the tax benefits, leverage, and in many states additional tax credits, one of the most important benefits of these types of policies is that they have removed the ''Use It or Lose It'' mentality normally associated with a traditional standalone long-term care insurance policy.

Right up there with costs, the most popular reason for not purchasing private long-term care insurance coverage was the fact that if they never needed the coverage, they would have lost all of the premium dollars they had paid over the years.

For example, say a consumer buys a $500,000 life insurance policy with an LTC rider. When the insured individual qualifies for LTC benefits (i.e., becomes unable to perform two of six activities of daily living (ADL) or becomes cognitively impaired), a set percentage of death benefit — 2% in this example — is available each month for LTC needs. This means that 2% of a $500,000 policy would equate to a payout of $10,000 a month for 50 months.

Another important benefit of the combo plans has been the ability to lock in and guarantee costs for long-term care premiums and, in doing so, prevent the significant premium increases that the purchasers of long-term care insurance have experienced over the last decade. These benefits, all the direct result of the PPA, have been responsible for an increasing number of requests from wealthy clients deciding to use a combo/linked plan rather than seeking the advice of an elder law attorney to artificially impoverish themselves and seek financial assistance from Medicaid.

Maximizing Tax Benefits for Life Insurance and Annuities

Before the PPA, the ''last in, first out'' nature of taxation for annuities meant that accessing cash value to pay for LTC expenses or LTC premiums was a taxable transaction for contracts with a gain. The PPA changed this. For example, if an annuity with significant gain is rolled into a new PPA-compliant annuity, the entire value of the annuity could be used to pay for LTC costs, and the taxes on the gain would forever be avoided.

Another new aspect of the PPA is the ability to do a full or partial §1035[1] tax-free exchange into a standalone long-term care policy from a life insurance policy or annuity. This is another way to eliminate income tax on gain in the policies when pursuing long-term care solutions. For example, someone with a $50,000 gain in a $100,000 annuity would normally first have to pay taxes on that gain. However, if the money were transferred via a §1035 tax-free exchange into a hybrid product, they could eliminate the entire tax on the $50,000 gain while leveraging the $100,000 principal into a much higher pool of dollars available to pay for long-term care costs, a significant benefit. Unfortunately, these new combo/linked features are not available in policies issued prior to 2010, nor can a policy issued prior to 2010 be modified to provide these new benefits.

Individuals today are able to place new money, or transfer existing annuities with an otherwise taxable gain, into a single premium immediate annuity (SPIA) and use the full proceeds of that otherwise taxable flow of income (exclusionary ratio) from the SPIA to pay for an individual's or couple's long-term care insurance premiums, but only if the premiums are paid directly to the insurer from the SPIA annuity.

Tax-Deferred Accumulation Planning

The third form of ''living benefits'' generically involves retirement cash flow. These are often referred to as private pensions, deferred compensation, salary continuation, supplemental executive retirement plans or supplemental owner's retirement plans. The common denominator involves the strategy of richly fund-

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[1] All section references herein are to the Internal Revenue Code (the ''Code''), as amended, or the Treasury regulations promulgated thereunder, unless otherwise stated.

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ing a life insurance policy, up to its modified endowment contract (MEC) limits, to intentionally build cash value over and above the expenses in the contract. Doing so allows the cash value to grow and accumulate, tax deferred, until a point in time where the full amount can be withdrawn, up to basis, and the balance borrowed as a loan. Assuming the withdrawal strategies are structured correctly, the loans never have to be paid back, meaning the withdrawals can be 100% income tax free so long as the policy survives the insured. This concept can be implemented through a variety of contracts with varying risk profiles.

For example, either a fixed-interest whole life insurance policy (WL) or a security-based variable life insurance (VUL) (which also serves as a framework for ultra-and high-net-worth life insurance known as private placement life insurance (PPLI) policy), or an indexed universal life insurance (IUL) can be used for accumulation purposes.

PPLI is most efficient for the ultra-high-net-worth individual. It differs from retail life insurance in several distinct ways. The institutional commissions are significantly lower than the traditional retail commissions. The health ratings of the class of people insured offer better mortality rates which the insurer passes on to the individuals being insured.

There are no penalties nor surrender charges for early withdrawals. There's also the benefit of using hedge funds as an investment vehicle rather than the traditional retail mutual fund sub-accounts. In addition, there are significant tax and investment advantages to using hedge funds in a tax-deferred life insurance policy where an investment manager doesn't have to pay capital gain nor ordinary income taxes every time a successful trade is completed. Recently, the government under §7702 has made it more advantageous for a larger percentage of one's premium dollars to be allowed to accumulate tax deferred in a life insurance policy without creating an MEC.

Also, among the various benefits of using life insurance contracts for accumulation purposes are no limits on contributions (unlike with qualified plans) and more flexibility in funding. Depending on the particular product, the plan design can be personalized and discriminatory, and money can be accessed tax free and prior to age 59 1/2 without penalties. In addition, there are no time limitations as to how long the accumulated assets can be held, thus offsetting the negative aspects of the SECURE Act which now limits to 10 years the time an inherited IRA can continue to accumulate tax deferred before it must be distributed and subject to income and estate taxes. Lastly, a life insurance policy as we all know also provides a leveraged death benefit that is 100% income-and estate-tax free, if it has been set up correctly.

In many situations the policy's premium can be shared with the employer for a key person, or for the employer themselves through various cost sharing strategies such as a split-dollar arrangement where there is an arbitrage for taxation on a corporate dollar in a lower tax bracket as opposed to an individual's higher bracket.

Life Settlement

Market History

The life settlement market evolved in the late 1980s as a result of the AIDS outbreak, when terminally ill individuals were allowed to partially liquidate their life insurance policies to generate cash to pay for their medical bills. Subsequently, the market expanded to include older individuals as well as those with health problems. Until the 2008–2009 financial markets crisis, settlement practices were considered questionable, causing a number of states to regulate this market for consumer protection purposes.

Who Is Eligible for a Life Settlement?

While a life settlement can be entered into by anyone owning a life insurance policy, only those who are at least 70 years old, in poor health, and worth at least $100,000 are likely to have their life settlement application accepted by their broker and turned into a funding source that is likely to provide an offer.

However, due to an ever increasing number of investors in the secondary marketplace, there is now an ability for a healthy 65 year old with an inadequately funded guaranteed universal policy, that has a minimum of $250,000, to arrange for a life settlement.

The special license process for a life settlement broker clearly defines the fiduciary role of the broker representing the seller and outlines how this role should be documented to safeguard the interests of all parties.

The problem is that the majority of clients, and many of their advisors, are not familiar with the concept of a life settlement. In most cases, if a decision is made to no longer maintain coverage, an insured will either surrender the policy back to the life insurance company that initially issued the policy, or they will merely stop paying the billed premium and, by virtue of default, use up the accumulated cash value until the cash surrender value is no longer sufficient to pay the premium required to maintain the policy's coverage.

A far better alternative may be to utilize the secondary marketplace to obtain a higher offer from an institutional investor. Consumers and their advisors must be made aware that the death benefit is not to be reduced or surrendered without first exploring the benefits of a life settlement option, or some form of a partial life sale with a retained interest.

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A life settlement, depending on a client's age and health, can provide an insured with an alternate exit strategy with a significantly higher payout than they would receive if they merely surrendered the policy for its cash value.

One such reason for the lack of discussion centers around the fact that many individuals, including their advisors, confuse life settlement with stranger owned life insurance (STOLI).

The latter occurs when an individual agent or broker induces an insured to purchase a life insurance policy for the sole purpose of selling it for a profit within a few years of purchase.

Such an arrangement is illegal, but a life settlement is not.

Clients need to be aware that an individual has the ability and right to sell a life insurance policy that is no longer needed or becomes too expensive, just as they would a home, a car, or any other personal property. One of the more common reasons why so few policyholders and advisors are familiar with the practice of selling an unwanted life insurance policy is that the insurance companies don't discuss such option, much preferring that the policy lapse — which allows them to keep all of the past years' paid premiums while never having to pay out a death claim.

Tens of thousands of American seniors ages 65 and older forfeit billions of dollars of life insurance coverage annually by lapsing or surrendering their policies, according to research at the Life Insurance Settlement Association's (LISA) Fifth Annual Institutional Investor Life Settlement conference (latest figures as of 2018). A survey of seniors conducted by Custom Market Research found that 55% allowed their life insurance policies to lapse and, further, 82% of the respondents were not aware that alternatives such as life settlement existed. In that same study, 79% of clients felt that advisors should inform them about a life settlement strategy. A study conducted by the Insurance Studies Institute (ISI) found that 90% of seniors who lapsed a life insurance policy would have considered a life settlement had they been aware of the strategy.

Recent Example

A recent case I just completed involved a 72-year-old man with a $750,000 policy and a $225,000 loan that accrued over the years as a result of him realizing that after the eighth year, he could maintain the policy without making a premium payment in the ninth year, and so he didn't make another premium payment for the next 11 years. In the process, he incurred significant loans, compounded by interest, that were not paid. In addition, there were net gains over the premiums paid as a result of increases in cash value and dividends.

At that point that I was asked to see if anything could be done to improve his situation as he didn't have the means to pay the significantly increased premiums to keep the policy in force, nor did he have the means to pay the additional taxes on the gains which would be due if the policy lapsed while he was still alive.

I introduced the concept of a life settlement and structured an arrangement with a buyer who was willing to take over the obligation to pay off the loan and continue paying the policy premium, thereby absolving the seller from a significant tax liability that he would have been responsible to pay.

Although the seller received no cash as a result of the sale of the policy, he was relieved of the potential tax liability and still retained a death benefit for a number of years, which made him and his family very happy.

The life settlement market, primarily funded by institutional buyers, has enhanced the consumer value of life insurance planning and has become a significant alternative to merely surrendering a life insurance policy that is no longer needed, wanted, or affordable.

This is of particular interest to many clients today, who are dealing with the harsh economic realities that their life insurance coverage is expiring prematurely as a result of sustained reduced interest rates and neglect on the part of their unskilled/amateur trustees, usually an eldest son or daughter, who wasn't aware that they should have been actively managing their policy by increasing their life insurance premiums to offset the lower interest crediting rates they were receiving from their insurance company.

A WORD ABOUT TAXES

Rev. Rul. 2009-13, issued on May 1, 2009, clarified that a policy seller may not use the amounts paid for cost of insurance charges to increase tax basis or reduce taxable gain.

Under case law discussed in the ruling, the IRS takes the position that a portion of premiums paid represents personal consumption of life insurance protection (the cost of insurance amount) and only the remainder of the premiums paid is the cost of an asset. As a result, policy sellers to third parties must obtain their information on cumulative cost of insurance from the life insurance company in order to calculate the adjusted basis (premiums paid less cost of insurance) and file their tax returns. Further, the IRS takes the position that the difference between policy cash surrender value and premiums paid — the net inside build-up the policy holder would have received upon surrender — is taxable as ordinary income, and the remaining balance is treated as capital gains.

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CONCLUSION: EDUCATE YOUR CLIENTS ABOUT LIFE SETTLEMENTS

The secondary market provides a better exit strategy for a client who finds their life insurance policy no longer affordable, no longer needed for estate tax purposes, requires cash today, or wants to provide a gift to the next generation today while still here to appreciate the results of such.

While the responsibility of managing a life policy rests with the owner, keep in mind that 90% of such owners are the sons, daughters, or friends of the insured acting as unskilled or accommodation trustees, who for the most part are completely unaware of what is required to properly evaluate and manage their life insurance portfolio to prevent it from expiring prematurely. The other 10% are professional trustees that are fully aware of their client's options.

Be aware that some life insurance agents — whom one would expect to discuss the life settlement strategy with their clients — are also registered representatives with their insurance company's sponsored broker-dealer and as a result may have restrictions on their ability to discuss such strategy. The reason is many life insurance companies would prefer to see a life insurance policy lapse in its 20–30th year because that way they get to keep all of the previous years' paid premium without ever having to pay out a death benefit. This adds significantly to their bottom line and they would prefer to continue this profitable practice of allowing approximately 8–10% of its in-force coverage to expire without ever having to pay out a death benefit. An educated consumer is not in their best interest.

So, rather than having your client merely surrender their life insurance policy back to the insurer simply because it's more convenient, or because they're not aware of any other alternative, consider educating your client on the benefits of retaining an independent experienced licensed life settlement broker who contractually affirms their fiduciary duty to the seller and assists your client in obtaining the best possible offer for the insured or trustee.

These amateur trustees, your next-generation client, could certainly benefit from being better informed regarding the matters mentioned above and could benefit from your advocacy and guidance. They and their families will thank you.

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He has appeared as a guest on Wall Street Week, Fox Business News & News 12. He's provided CPE & CLE continuing education credits to NYSBA, ABA, AICPA, NYSSCPA, & the estate Planning Council. He co-authored an American Bar Association Flagship publication, Jan 2017, titled; "The Advisors' & Trustees' Guide to Managing Risk" The Jan 2019 issue of Commerce Clearing House, referred to him as; "One of today's best brains in life Insurance.