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Dear NCBA Attendee

May 16, 2023

I hope you found our session this evening informative, useful and of interest. Please let me know if I can be of assistance in clarifying any matters we covered.

I'm happy to share my 37 years' experience as an independent CFP, CLTC, and ABA author focusing on the subject of Risk Management and act as a resource for you & your Family in this ever-changing world of providing information regarding properly utilizing life, disability and traditional LTC or the new Combo LTC & Life Insurance plans for its Death Benefit or for its Living Benefits.

Call or email if I can answer any general questions or if you'd like to discuss the subject in greater detail including specific features, benefits & costs regarding any of the topics discussed during my presentation or in the enclosed articles.

Best Regards

Henry Montag, CFP, CLTC.

Bloomberg Tax

Tax Management Estates, Gifts and Trusts Journal™

Shoemakers With Barefoot Children: What Estate Planners Need to Know About Their Own Planning

*By Henry Montag CFP and Martin M. Shenkman, Esq.**
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New York, NY

INTRODUCTION

Too many estate planning attorneys are simply living as the barefoot shoemaker. This article won't introduce planning concepts that are new to estate planners, or that are technically complex. The goal of this article is to motivate you the reader to make an action plan and protect yourself and your loved ones, if you have not already done so (and too many of us have not!). We won't discuss tax planning, you're likely expert at that. But we will discuss, the basic insurance protection and legal protection we all should evaluate for ourselves. We'll vary from the more typical article of speaking in third person and will offer some comments about our personal planning. Not because the authors are models of planning, but rather to emphasize how important these obvious but too often overlooked steps are for all of us. If you're like us, your planning always struggles with the: "I'll get to it as soon as I finish . . . [fill in the blank which likely includes a long list of client matters]."

Example: One of the authors spoke on a panel presentation a few years ago for a group of estate planning attorneys in New York City about creative uses of irrevocable trusts. At one point in the discussion one of the panelists asked the audience for a show of hands as to how many had irrevocable trusts for their own asset protection planning beyond just a simple life insurance trust. The two speakers raised their hands. No one else did. Why this simplistic story? To emphasize the premise of this nontechnical but perhaps important article. We need to give attention to our planning just as we do to client planning.

STEPS YOU SHOULD TAKE

Make an action plan of key steps you need to address. Prioritize that plan and make a decision to address perhaps one or two items every few months. With the pressures we face in our practices, the idea of crafting and implementing a comprehensive plan over some reasonable number of months, as we do for our clients, likely won't happen. Write down your plan. Tell your spouse, partner, colleagues — someone to hold you accountable to address your action plan. Trite? Perhaps, but again the reality is that if most of us had addressed our personal planning with the same zeal with which we address client planning, we'd have skipped over this article.

Example: One of the authors and his wife applied for long-term care coverage as their 50th birthday presents to each other (you can tell how romantic we both are). While the applications were pending the spouse was diagnosed with a health issue and could not obtain coverage. Had the application been made even six months earlier the coverage would have been obtainable. Waiting to act, whether on insurance or other matters, is a risky gambit, even for estate planners.

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Check your wallet! Take an inventory of your information no different than you would do for a client. If your firm has a questionnaire or estate planning organizer, fill it out just as you would ask a compliant (not average) client to do. Of course, you don't need to complete an organizer for you, as you know the relevant information and hence the planning and documents that are necessary. That may be true but consider that your spouse/partner/family may not know that information. Further, if you are incapacitated the data in that questionnaire could be critical to your family or loved ones. Further, you have standards and processes by which you handle most client estate plans, use the same approach for your own planning. The structure that your typical approach provides to facilitate your completing client work efficiently and properly should be used for your own planning as well. That structure may well be more important for our planning since many of us will focus less on our needs than on our clients' needs.

ASSET PROTECTION PLANNING

Malpractice cases against estate planning attorneys are growing and should be a concern of every practitioner, no matter how careful or capable we might view ourselves.[1] Too many of us are simply too busy handling client matters to focus on our own personal planning. We might assume that our firm is addressing defensive practice techniques. But this issue is far too important to leave to assumptions. Consider that many CPA firms and appraisal firms limit their liability to fees earned in their engagement letters. Because lawyers are prohibited from doing so by ethical rules, we may have more exposure that anyone else on a client's estate planning team. That might suggest that we should take more precautions than other advisers do.[2]

We should address malpractice protection planning from several perspectives, including defensive practices, firm malpractice coverage, and personal asset protection planning.

What defensive practices can our firms implement specifically as to estate planning matters? While practitioners are familiar with many or all of these techniques, have they really been addressed? Evaluate prospective clients with internet or other searches not just conflict checks. Do you or your partners accept less desirable clients because of pressures to generate origination and billing?

Insist on written signed retainer agreements from every client. Incorporate disclaimers on every planning memorandum. Many CPA firms do this. Insurance and financial consultants include lengthy disclaimers on projections and statements (look at the fine print at the end of your investment statements). Few estate planning attorneys seem to do so despite not being able to limit liability.

Does your retainer agreement cover more than your rates and fees you might charge? It could address client responsibilities (e.g,. to provide complete and accurate information, to return for annual reviews, etc.), that there are no guarantees of results, that there are risks associates with every planning technique and that many tax planning steps may have offsetting negative tax consequences, and that tax laws can and do change frequently and could thereby undermine a plan that may have been beneficial when first proposed, etc. Do you memorialize in a written client communication risk of a particular transaction? A common issue in malpractice cases is "The attorney never told me that there were risks." Make a habit of documenting concerns in writing.

What about your own personal asset protection steps? Have you maximized retirement plan savings that may offer protection? Is your home held as tenants by the entirety if you are married and applicable state law provides protection? Do you have significant nonpension assets held in irrevocable trusts to perhaps provide some protection of those assets from malpractice claimants? Many of us discuss spousal lifetime access trusts (SLATs), domestic asset protection trusts (DAPTs), hybrid-DAPTs, special power of appointment trusts (SPATs), irrevocable life insurance trusts (ILITs) and other techniques with clients. But have we used that same arsenal toward protecting our own assets? If significant assets are to be transferred to irrevocable trusts, have we evaluated the possible increased need for various additional insurance coverages?

Example: One of the authors embarked on the path of creating his own planning when decades ago a client, with whom he was discussing the importance of an insurance trust inquired: "What do you have in your insurance trust?" The response was can I answer that question next week, and that Sunday, his first irrevocable trust was created. We shouldn't have to wait for clients to embarrass us into carving out the time to address our own planning.

INSURANCE PLANNING

Insurance planning needs to be evaluated based on your personal circumstances. Needs change over time

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[1] *Raia v. Lowenstein Sandler LLP and Eric D. Weinstock*, No. A-1365-19T1, 2020 BL 230787 (N.J. Super. Ct. App. Div. June 22, 2020); *Wellin v. Nixon Peabody, LLP*, No. 20-1120, 2021 BL 447527 (4th Cir. 2021).

[2] *See* Sandra D. Glazier, Martin Shenkman, Jonathan G. Blattmachr and Joseph Garin, *Wellin v. Nixon, Peabody, LLP — Case Lessons on Defensive Practice*, LISI Estate Planning Newsletter #2934 (Jan. 20, 2022); Martin Shenkman, Sandra Glazier and Howard Zaritsky, *Raia Lowenstein Sandler LLP — Thoughts on a Recent Malpractice Case*, LISI Estate Planning Newsletter #2724 (May 16, 2019).

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so periodic reviews are critical. For example, during the course of a young couple's life there are a number of times you would be in a position to offlay a portion of your personal or business owner risk to an insurance company.

For example, when. . . .

- You buy a first house and obtain a mortgage. A child is born and there's a need to provide for family income and an educational fund. A second child is born and/or when they move into a larger home. You're involved in a law practice or in another profession or business and you have or should create and fund a buy-sell agreement.
- You obtain disability insurance to guarantee your monthly income if you can't work.
- You a highly compensated attorney, executive, or business owner uses life insurance to supplement your retirement.
- You protect your retirement savings from an unexpected, unreimbursed long-term illness.
- You face a state and federal estate tax and you purchase a life insurance policy.

Years ago, purchasing life insurance to protect a family or business interest was simple. You had a choice of either whole life or term, both with 100% guarantees as to the premium you would pay, the duration of time you were covered, and the amount of the death benefit. However, ever since the mid 1980's the number of insurance options has grown. While that makes it more complex, it also provides greater flexibility. There are now more than six types of policies while perhaps 50–60% of current coverage that's in force today is guaranteed. The insurance industry has decided to offlay a greater percentage of the investment and mortality risk they've usually assumed, onto you the insured. Unfortunately, many of you still think that all coverage you have or are considering is guaranteed like it used to be, but that is often not the case

You have to be aware of and understand the greater share of risk you as an insured have, often unknowingly, assumed based on the type of policy you are considering, the duration of the coverage, and the premium you are considering paying.

Since this is not your father's/grandfather's life insurance policy a consumer must be more vigilant with any type of coverage they purchase or are responsible for as either an unskilled/amateur trustee for your family, or as a professional trustee for your clients' ILITs. Point is that life insurance can't be placed in a drawer and forgotten about. Life insurance today is a "Buy and Manage" asset Not a "Buy and Hold" asset, as so many consumers mistakenly believe. Life insurance must be actively managed by evaluating its performance on an ongoing basis just as you would your stock and bond or real estate portfolio.

A WORD ABOUT LIVING BENEFITS

Again, as planners we are all somewhat familiar with the basics, or much more, of life insurance planning. The coverage we need will evolve over time as our circumstances and needs change. When we are younger and growing our family, we need life insurance to protect against a premature death. In the event you become disabled and can't earn an income, a robust disability insurance policy with a benefit period to age 65 along with a built-in inflation factor, and a definition that protects you in your specific occupation even if you can only work part time is critical if you aren't able to earn an income after your six-month short term disability coverage ends

Life insurance as a "Death Benefit" can serve a variety of purposes in addition to protecting your loved ones in the event of your premature death. It provides the funds that assures that the value of the deceased's business partners interest will immediately be paid to the deceased's partners family in exchange for their percentage ownership share in the business or professional entity according to the terms of a funded buy-sell agreement. In other cases, the death benefit is used to pay for future estate taxes.

It can also act as a backstop to a non-reciprocal SLAT or other irrevocable trust plan from the risk of premature death, funding a buyout for our practice and much more. If we endeavor to protect assets by shifting some of our nonretirement plan wealth to irrevocable trusts, expanded insurance coverage in light of our reduced personal net worth may make sense and should be evaluated.

As an "Asset Class" life insurance contains several "Living Benefits" you should become familiar with. It can serve as a tax-deferred savings vehicle over and above any IRA or 401k plan limits to supplement our own retirement income with no interference as to governmental regulations.

As we age, and perhaps find ourselves in a position where life insurance coverage or disability coverage is no longer needed, it may make a great deal of sense at some point in the retirement cycle and nearer the end of our career to redirect the premium we've been paying for disability insurance and instead use it to pay for our long-term care costs by either purchasing a traditional long-term care policy, or a combination/linked life insurance policy that gives the insured, or their trustee if held in a trust, the ability to withdraw dollars from the death benefit of the life insurance policy tax free up to the federal limit geared to inflation, to pay for qualified long-term care costs.

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Or we could use the accumulated cash value of a life insurance policy to supplement our retirement income through its distinct ability to defer any gains during the entire accumulation period and then when desired, without any governmental regulations, we're able to take tax-free distributions through a series of surrenders and loans that never have to be paid back, as long as the policy survives the insured.[3]

In some cases, such a conversion may be a better allocation of resources if the objective is to support our retirement. Whenever such a decision is made it's always important you compare the alternative of turning an unneeded life insurance policy back to the insurance company for the cash value, as opposed to selling the policy on the secondary market to an institutional investor as a life settlement where the payout can be significantly greater than the stated accumulated cash value within the insurance policy.

HOW NOT TO DO RETIREMENT PLANNING

We should all be mindful of any mandatory retirement ages our firm has and what planning we might need to be prepared for that eventuality. If your firm requires retirement by age 68 unless the management committee approves an additional year to year of practice, then we should be prepared financially for that upcoming date. Ideally planning for that should begin decades prior. That should include all the obvious steps we either suggest to clients or hear their other advisers recommend, budgeting, financial modeling, asset allocation and so forth.

AN EXAMPLE

One of the most significant mistakes I've seen in this area of retirement planning involved a 62-year-old senior partner that had previously retired from one of the major accounting firms. In order to maximize his retirement income, the agent from a major life insurance company that was contracted to provide advice to the retiring partners suggested he take his full pension, leaving no benefit for his wife should she survive him. It was explained to him that he could allocate a portion of the additional income he received to purchase a $1.5 million dollar association group life insurance policy which at his death would provide the same amount of annual income the wife would have received from his pension had he chosen the 50% survivor option. However, using this strategy, at the wife's subsequent passing the $1.5 million life insurance proceeds would be left to their two children as an inheritance. Had he taken the 50% survivors benefit that option would not have been available at the wife's subsequent passing. It made sense and he went ahead with the transaction[4]

Several years later this client was referred to me by his attorney for a second opinion regarding his entire life insurance portfolio. It was soon discovered that the policy increased in five-year increments and by the time the client turned age 75 his premium would have increased from an initial $13,000 annual premium to $31,000, and by the time he was 85 the premium would have increased to $59,000. Once the client realized the mistake that he made and what was going to happen, he purchased a guaranteed universal policy with a smaller death benefit in exchange for a manageable premium that he could afford long term and which would be guaranteed to last till the client was age 95.

A FURTHER WORD ABOUT ASSOCIATION GROUP TERM AND INDIVIDUAL TERM INSURANCE

Association group term life insurance for accountants and attorneys is initially the least expensive form of term life insurance up to age 45. However, if you plan to maintain your coverage to age 85 and beyond association term is not the right product. Reason being in later years the premium becomes exorbitantly expensive, and the death benefit gets reduced at age 75.

Term insurance through its conversion privilege provides an opportunity for an insured in poor health to convert their term policy for a permanent policy without any evidence of insurability. However, this conversion option is only available up to a specific age usually to age 65 or 70. If your health has deteriorated it's important that you take advantage of this important conversion feature before it expires.

For some of us the thought of retirement is dreadful. If that is the case, then planning for the dreadful might not receive much priority. "Lawyers are living longer, their practice settings are changing, and the nature of the work itself is in flux. Retiring in place is harder to do. Yet, 73% of lawyers in private practice say they want to practice law until they 'die at their desks' "[5] If the latter is your goal, that too should be planned for. As a CFP practitioner of 35 plus years, I can attest to the fact that it's far better when you plan ahead and allocate a sufficient portion of your current

[3] Randolph Whitelaw and Henry Montag, *The Advisors' and Trustees' Guide to Managing Risk*, American Bar Association (2017).

[4] *Id.*

[5] Edward C. Winslow III, *Not Fade Away: Can Old Lawyers Age Successfully?*, Law Practice Today (Jan. 14. 2020).

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income to a retirement plan that provides sufficient assets to earn a desired preset retirement income at a preset age.

CONCLUSION

A life insurance policy today is far more flexible, comprehensive, and complex than a typical life insurance policy issued just 15 years ago. It's more important than ever to have the right type of a policy for the specific objective you have in mind. If you don't have the expertise in this area develop a relationship with an independent experienced financial, insurance, and estate planning professional who that can assist you and your family.

As a profession, estate planning attorneys are expert at helping clients identify and then solve a wide range of planning issues. Some of us need to direct that same skill set to addressing our own personal planning.

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Tax Management Memorandum™

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-

[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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What Your Clients Wish You Told Them About Fixing & Preventing Mis-Managed Life Insurance From Affecting Their Estate Plan

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Attorneys establish trusts and business agreements for their clients for a variety of reasons. Perhaps an irrevocable life insurance trust (ILIT), to provide liquidity for estate taxes. A grantor trust for a parent or grandparent wanting to provide family income, professional management, or guidance for an inheritance earmarked for the next generation. A special needs trust (SNT) to provide for the welfare of a child after their parents are no longer here to take care of them. A buy sell agreement to assure the orderly transfer or disposition of their business interest for the benefit of their family and business partners. Since over 90% of the Fortune 500 corporate clients have a deferred compensation plan (DCP),[1] many of their small business owner clients have similarly requested to establish a deferred compensation plan to supplement their retirement income, or perhaps to allow a class of key employees the ability to defer a portion of their income as a perk at their place of employment.

Similarly, their CPA's will prepare their Crummy letters and make certain there's sufficient funds available to pay the ongoing necessary premiums to keep the coverage in force beyond their life expectancy.

THE ROLE OF A LIFE INSURANCE POLICY

What do all of these trusts, and agreements have in common? There's a life insurance policy used to fund each of the situations mentioned above. It's therefore important for the grantor as well as the amateur trustee, usually the eldest sibling, to become more knowledgeable regarding their responsibilities associated with managing the various types of life insurance policies funding their trusts and agreements. The purpose of this article is to familiarize the reader with information that can be used to better understand the opportunities that exist, and identify the proper strategy required, to provide guidance to your clients as well as their children acting as "amateur/ accomodation trustees," that have received very little guidance regarding their responsibilities and the consequences of their actions and inactions when it comes to dealing with the current mismanagement and neglect of many of their existing life insurance policies in their portfolios. Life insurance has two purposes that can be used individually or combined to provide a traditional "Death Benefit" as well as a lesser known "Living Benefit."

Regardless of the use or purpose it's essential that a client understands that life insurance policies do not come with an automatic management function and that each of the policies funding their respective trusts

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[1] Reg Ed Non Qualified Deferred Compensation Course, p. 7 (Mar. 2017).

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and agreements require an ongoing review process because personal events and economic situations can and do change. How would you as an amateur trustee or an advisor to an amateur trustee of an ILIT react to receiving a notice from the insurer stating that the $1,700,000 life insurance policy in the trust is going to lapse in the next 12 months unless a significantly higher premium is paid? The insured is age 81, in good health and so far, has paid over $400,000 in premium. Your action is needed immediately. What would you advise? The point is if you, the advisor, or your amateur trustee client doesn't have the necessary skills, to properly evaluate the existing policy coverage it's your responsibility to retain the services of someone that does.

HOW DID THAT HAPPEN?

All too often a person, be it the client's advisor or eldest child will accept the title of trustee but won't fully understand the ramifications, the responsibility, nor the fiduciary liabilities that comes along with that title. One of the prime responsibilities of a trustee using any type of a life insurance policy is to make certain that the policy will be in force when the grantor dies. Let's look at a typical situation occurring today. In 1990-2000 if a client purchased a one million dollar life insurance policy it would have been suggested that the policy be owned by someone other than the insured outright, or if management and or creditor protection was desired, by a trustee of an ILIT, both to keep the death benefit out of the grantor's taxable estate. In 10% of the situations the grantor would have chosen to use an institutional or corporate trustee. However, in the other 90% it was usually the grantors' eldest child that was asked to serve as a trustee. A trustee that had the responsibility but not the necessary knowledge, experience, nor guidance to properly manage the life insurance policy to prevent it from expiring prematurely. Nor did the trustee realize that they assumed 100% of the performance risk for the life insurance policy that they didn't know was not guaranteed to last for the remainder of the insured's life.

WHAT HAPPENED?

The death benefit coverage of a life insurance policy could significantly be shortened as a result of 25-plus years of reduced sustained interest rates and neglect on the part of the amateur trustee, that wasn't aware that the life insurance premium he/she was paying should have been increased. The problem compounded itself over the years to the point where many 80-year old's today are currently discovering that their life insurance coverage is only going to last for just a few more years unless a significantly higher premium is paid to make up the insufficiency created over the last 25-plus years. How can that be asked of the client when they paid all of my premiums on time, in full and never borrowed any of the cash value. What they nor their amateur trustees, and advisors didn't understand is that 45% of the life insurance contracts they purchased over the last 25 years were non-guaranteed universal life insurance policies that were not guaranteed to last for the rest of an individual's life. The duration of the policy was based on an anticipated interest rate 10, 20, or 30 years ago that didn't materialize, and was never adjusted to coincide with the continuous reduced interest rate environment. This situation continued throughout the early 2000's when insurers began offering guaranteed universal life policies. The difference between a non-guaranteed universal and a guaranteed universal or a whole life policy is that the latter has a higher premium that's used to build up a sufficient amount of cash value designed to guarantee that the policy will last for the rest of an individual's life, or to a desired, specific age, in the case of a guaranteed universal policy.

However, with any non-guaranteed universal life policies purchased prior to the early 2000's, It was the owner/trustees' responsibility to evaluate the performance of the policy to make certain that any shortfalls, between the assumed interest rate when the policy was first taken out, and the actual interest rate that was credited to the policy in each of the last 20-30 years, be made up by increasing the premium paid to the insurer.

THE ROLE OF THE TRUSTEE

Unfortunately, neither the amateur trustees nor their advisers realized that a non-guaranteed life policy required this type of active management, and as a result 25-35% of these non-guaranteed universal life insurance policies are now expiring prematurely.[2] This situation has grown increasingly worse because just as people are living longer,[3] their non-guaranteed life policies are expiring earlier.

Most life insurance policies, even whole life policies, require some form of active management due to the fact that dividends which are often used to buy term insurance or reduce premiums are not guaranteed, and should be considered a "Buy and Manage" asset rather than the "Buy and Hold" asset they are often erroneously considered.

Once a problem is discovered trustees and beneficiaries alike often begin looking at who is at fault and

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[2] Randy Whitelaw and Henry Montag, *The Life Insurance Policy Crisis*, ABA (Jan. 2017).

[3] Society of Actuaries Report (Nov. 2014).

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who can be blamed for their problem. "Isn't it the agents' responsibility to make sure I'm billed properly?" or "Shouldn't the insurance company have billed me correctly?" or "Shouldn't my attorney that drafted the trust or my CPA who is involved in all my financial decisions have advised or informed me?" Despite the fact that 90% of the trustees that serve in the capacity as an amateur trustee have no skills and receive very little guidance when it comes to dealing with maintaining a non-guaranteed life insurance policy, the answer to the above questions is "No."

Neither the agent nor the company is responsible. It's the trustee that has 100% of the responsibility to manage the policy and only the owner/trustee can make a decision to increase or decrease the billed premium of the policy funding the trust.

JUDICIAL DECISIONS

In August 2012 the Office of the Comptroller of the Currency (OCC) issued guidelines[4] which directed financial institutions serving as corporate trustee of an insurance trust to treat life insurance as they would any other asset. Meaning that life insurance, like stocks, bonds, and real estate, requires active management.

Providing a policy performance evaluation and then monitoring it every two to three years, depending upon product would be a good idea for all amateur trustees. This is similar to the directive issued to corporate trustees under the Uniform Prudent Investor Act (UPIA), that also mandates that life insurance be treated as any other trust asset.

IMPACT OF COI

Why is all of this attention suddenly being paid to this topic? Very simply life insurance companies more so than many other financial organizations have been adversely affected by the sustained reduced interest rate environment and are currently seeking to do whatever they can to offset their losses.

Please inform your clients that the life insurance company has no obligation to the insured nor the beneficiaries. Clearly their obligation is to their stock or shareholders. When a life insurance policy lapses, it means the insurer gets to keep all of the premiums that were paid, and they will never have to pay out a death benefit. A very profitable situation for the insurers as all they're required to do is provide a policy stating the coverage, send out the premium notices and the annual summary statements, that most people don't read, and by virtue of inertia individual life policies are expiring years earlier than anticipated. To further enhance this process an increasing number of insurance companies are now exercising their contractual right to increase the internal cost of insurance (COI) for the 45% of the existing non-guaranteed universal life insurance policies. This action in addition to 25 years of reduced interest rates and neglect has caused a 'Perfect Storm' which is now further exacerbating an already deteriorating situation causing more life policies to expire even sooner. So, just as people are living longer their life insurance coverage is expiring sooner.

DO I STILL NEED THAT POLICY?

Considering the uncertainty of estate taxes, many of your clients are now pondering what to do with the life insurance they had previously purchased with the intent of using it to pay their federal and state estate taxes. While that topic is a subject to be discussed in a separate article, the question for many becomes "Should I continue to pay an increasing premium for insurance I may no longer need? Or should I give up my coverage? If I decide to give it up, exactly what should I do? Should I surrender the policy back to the insurer in exchange for the cash value? Should I merely reduce the death benefit and pay less premium?" Should I just stop paying the premium all together and keep the policy for as long as the coverage will last? Depending on an individual's health and age, a smarter but less well-known option is an alternate exit strategy known as a "Life Settlement." This is a process where the insured sells all or a portion of their existing life insurance portfolio, just like they would a car or a house. Such a sale is transacted on the secondary market in which a hedge fund/institutional investor acts as a purchaser, and the seller usually receives a significantly higher payout than if they would have surrendered the policy back to the insurer. Such a strategy can also be used to rescue a failing life insurance policy as a result of neglect or even unpaid loans against the cash value that could result in a significant tax bill, if the policy were to lapse, by turning an increasing premium bill into a liquid asset.

DO I NEED A GUARANTEE?

Going forward, today a client can obtain a guaranteed universal life insurance policy that can be designed to last for as long as they choose. Naturally the longer a person wishes to guarantee that their life policy will remain in force, the more it would cost and vice versa.

Guaranteed duration is especially important for a family setting up a special needs trust (SNT) when

[4] *See* Comptrollers Handbook, Asset Management (AM): Unique and Hard-to-Value Assets (Aug. 2012).

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they want to make 100% certain that the life insurance policy they purchase, remain in force for the duration of their lives to support their child after they're gone or to provide an inheritance as a legacy allocated for the next generation. The solution is a personal choice predicated on one's personal finances and thoughts regarding longevity. An ongoing evaluation of one's policy can also determine that an individual age 75 or 80 with a significant health issue and an expected shortened life span should not be paying premiums to keep a policy in force to age 95 if their prognosis determines that they may not live beyond age 85. Although guaranteed universal policies are now available, a guaranteed policy is more expensive than a non-guaranteed policy, so make certain as a consumer you're educated and know what you're buying.

TERM OR PERMANENT LIFE INSURANCE?

A buy-sell agreement between business partners can either be funded with a less expensive term life insurance policy, which is guaranteed to last anywhere from five to 30 years, or up to age 83, or it can be funded with a permanent life insurance policy that costs significantly more but lasts a lifetime because it builds up cash value. This cash value can later be used to supplement their retirement income. If a business is first starting out, or if cash flow is an issue, they should use a term policy to provide the maximum death benefit for the longest period of time, for the least amount of premium outlay. But if your client is involved in a well-established company where cash flow is plentiful, they may consider utilizing a permanent life insurance policy for its tax deferred accumulation benefits which, in addition to providing life insurance coverage, can later be used as an asset class to supplement their income at retirement. Keep in mind that some insurers only allow a term policy to be converted to a permanent product to age 65, or 70. This conversion privilege is extremely important to any individual that developed an illness, as it allows them to convert the policy's coverage to one that lasts a lifetime without any evidence of insurability. This opportunity is often missed and once it passes, is irreversible. point of information, association group term insurance is a great buy up until age 45, but with increases every five years at 50 it's terrible so shop around at age 49.

LIFE INSURANCE AS AN ASSET CLASS

Sometimes life insurance is not used for its death benefit and is instead used for its living benefit, as an asset class, i.e., providing a favorable tax deferred accumulation build up and tax-free distributions. Such would be the case if a client involved in a C-corp decided to use life insurance as an asset class for its living benefit via a deferred compensation plan (DCP). In this manner a key employee or the owner of the business itself, depending on certain restrictions, can reduce their current income and place the reduced amount of salary in a life insurance policy with just enough life insurance to not violate MEC rules, and still be able to utilize the life insurance policy's tax deferred accumulation status. Doing so would not only build up a tax deferred accumulation fund but can also years later, distribute the income from the cash value on a favorable income tax free basis to supplement their otherwise taxable retirement income.

Mechanically this can be done through the use of a series of withdrawals up to basis, and then loans that never have to be paid back as long as the death benefit survives the insured. A split dollar arrangement can also be used to make certain that the corporation gets back 100% of their initial outlay from the death benefit. A similar arrangement called a supplemental executive retirement plan (SERP), may be used in an S-corp or LLC for an employer, based on various percentage ownership rules, or an employee but only on an after-tax basis.

TO CLARIFY MATTERS

It's solely up to you, the clients trusted advisor who sees their client on an ongoing basis to protect your client's current life insurance portfolios. A useful tool I use in my practice to record all available options including the life insurance, is a Letter of Intent Statement (LOIS) where I have the grantor meet with the trustee on an informal basis to discuss in plain and simple language the grantor's intent and to assure the trustee's understanding of what needs to be done under various circumstances. I then turn this into an informal letter given to the trustee by the grantor. This letter along with an Adequate Funding Statement (AFS) obtained from a client's CPA or retained independent life insurance consultant, is used to ensure that the life insurance policy chosen is sufficiently funded to meet the grantor's objectives, and that they are periodically updated and reviewed to keep current with the grantor's wishes as to beneficiaries, duties, and allocated percentage distributions.

IN SUMMARY

Remember, your client may not be not familiar with their life insurance portfolio, may not know that it can expire years earlier than originally anticipated, is not comfortable talking about the subject, and does not understand how non-guaranteed life insurance and in-

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terest crediting rates work. In many cases the existing policy has not seen the light of day since it was purchased many years ago. Therefore, it becomes imperative that you, as their adviser, take a proactive role, and advocate for the next generation to assure that your client is aware that reduced sustained interest rates, neglect, and most recently the increased COI's has adversely affected the duration of their existing life insurance policies. There is perhaps no better way to meet and engage your next generation clients than to initiate a conversation with them regarding the consequences of the current mismanagement of their existing life insurance policies and to let them know that they need to locate, evaluate the performance, and actively manage their life insurance portfolio in order to preserve the life insurance inheritance left by your client, their parents, for them and their children.

While avoiding a policy lapse as a result of inadequate funding is the primary goal, it is important for the client to not waste assets and maximize the value of the life policies they currently have, as compared to what other policies may be available in the marketplace today. To assure that this is done, a client should be referred to an independent and experienced life insurance consultant to assist them in ordering a 'historic projection' to help determining whether they can take action today, which will prevent them from becoming a part of the increasing number of individuals whose life insurance policies have become compromised.

Doing so will allow a trustee to see how the policy might perform going forward based on the policy's current values, rather than on the originally illustrated projections that never materialized. A trustee may need to make some changes with or without additional costs based on the client's current objectives rather than on the original objectives made years ago that may no longer be relevant today. Trustees may find new features such as long-term care riders that pay for qualified long-term care expenses directly from the death benefit of a life insurance policy on a tax-free basis which were previously unavailable. Improved life expectancy as a result of modern pharmacology is now reflected in reduced pricing of new policies. Insurers are now offering guarantees which previously didn't exist.

In some cases, it may be less expensive for a trustee to purchase a new policy, even though the insured is older, through the use of an older policy's cash values transferred through a I.R.C. §1035 tax free exchange. This action should only be taken after weighing such considerations as changes in an insured's health, new surrender charges, and the beginning of a new contestability period. Other options may include reducing the current death benefit or increasing the premium. As previously mentioned, if the other options don't solve the problem a trustee should consider the sale of all or a part of a policy to turn an increasing premium into a cash asset as a result of a life settlement to a third-party institutional investor, or a combination of the above-mentioned strategies.

While it may be easier for an attorney to draft an exculpatory clause in a client's trust than to provide guidance to an amateur trustee, the rewards of that guidance will be far greater and appreciated by your next generation client. The estate planning attorney or the client's CPA is the logical choice as the professional advisors who are in the best positions to arrange, invite, and manage such an initial meeting with the assistance of an independent experienced life insurance professional.

The point is, the sooner the problem is brought to the attention of the client, insured, owner, amateur trustee, grantor, or beneficiary, the more options they will have available, and less costly it will be for them to resolve their problem.

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