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Financial and Estate Planning

ESTATE PLANNING REVIEW THE JOURNAL

OCTOBER 22, 2015
ISSUE 861

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INSURANCE PLANNING

New Developments and Changes to the Life Insurance Industry

Ben Baldwin, Lee Slavutin, and Richard Oshins analyze recent events in the insurance industry.

Sidney Kess: Ben, in recent years, there always seems to be something significant going on in life insurance, and you recently offered a column in ESTATE PLANNING REVIEW—THE JOURNAL["The Changing Landscape of Life Insurance Company Risk," August 20, 2015, page 147], centering on some of the hot issues relating to insurance. Could you please comment on some of these items?

Ben Baldwin: Yes Sid, there is a great deal to talk about the changing landscape in life insurance company risk. We have two major trends causing life insurance companies to take actions that are changing their risk parameters relative to what they have taken in more normal times. Life insurance companies run on interest rate spreads as a result of their general account reserves consisting of about 80 to 90 percent bonds so the following to trends are dictating the actions of life companies:

1. Interest rates continue to surprise by being persistently low, and there really is no end in sight.
2. Regulations continue to require life insurance companies to hold higher reserves.

One action that some companies have been taking has been to sell themselves or certain parts of their business to private equity firms. Currently over 22 insurance companies are now owned by private equity firm. Specific examples are:

- Apollo Global Management, LLC supporting Athene Holding Limited, a Bermuda-based insurance holding company's acquisition of the Iowa domiciled annuity and life insurance company, Aviva, USA from Aviva PLC in October 2013;
- Guggenheim Capital's acquisition of Sun Life's variable annuity business and Security Benefit Life Insurance Company; and
- Harbinger Group's acquisition of Fidelity and Guarantee Life (F&G).

The question is, how will these private equity firms generate positive returns for their firms by investing in the life insurance industry during these troubled times of low interest rates, unprofitable legacy products, and increasing regulatory burdens? One reason is that insurance companies and books of unwanted legacy businesses are available at low cost, at book value, and below. This was demonstrated by Harbinger's purchase of F&G from Old Mutual at 35 percent of book value in 2011.["Private Equity Firms Find Bargains In Insurance Deals," *InsuranceNewsNetMagazine.com*, by Linda Koco, December 2012]

It gives the private equity firms, in the business of managing assets, the opportunity to manage general account assets more profitably, albeit with possible exposure to higher risk. It gives the private equity firms the right to service closed books of business, such as the Sun Life variable annuity business, for a fee and to manage the assets supporting the product. It also offers private equity firms (PE) the opportunity to increase business, as has happened in the indexed annuity space, increasing the private equity firms' market share from 5 to 15 percent in one year and tripling their market share in fixed annuities. Of the top five fixed annuity sellers in 2014, three were owned by private equity. ["Private Equity Firms Growing in

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CRN 201710-196959

Fixed Annuity Market," *Annuityfyi.com*, by Rachel Summit, December 2012]

So, the question from the advisor's standpoint is, first, who does own my life insurance company, and second, what is that private equity firm's plan for squeezing property or profit out of the acquisition?

Another action life insurance companies are taking is "jurisdiction shopping". That is, moving its domicile from a state with conservative accounting rules to a state with less conservative accounting rules. Life insurance expert and critic Professor Joseph Belth thinks that the Iowa rules relating to parent company guarantees to wholly owned subsidiaries allow Iowa-domiciled companies to engage in improper accounting practices that significantly distort the financial condition of the subsidiary and the parent.

...the bottom line is that the stress of low interest rates and increasing regulatory issues are causing life insurance companies to take actions to lower reserve requirements and increase returns that truly change the landscape of life insurance company risk that advisors need to be aware of.

An example of this: *Ross v. AXA Equitable Life Insurance Company*, in which policy owner Ross (probably with the assistance and advice of his full estate and financial planning team), made a decision to buy his required life insurance from AXA, based on all the available facts at the time of purchase. Later, he learned that AXA had issued $1.9 billion of parent company backed letters of credit to secure reinsurance obligations. AXA then moved the letters of credit into its Bermuda-based captive reinsurer. As a result of the movement of the $1.9 billion in letters of credit from the parent company, AXA received an $11 billion credit reserve, which reduced its aggregate reserve requirement and increased its total adjusted capital. These parental guarantees increased the company's risk-based capital ratio by 127 percent, which made the company appear more financially stable than it was.

The case was dismissed by the District Court of the Southern District of New York on July 21, 2015 [Case No. 14-CV-2904], because Mr. Ross hadn't been hurt. Nothing had failed in the way of the delivery promises of his contracts. He had brought the suit because he felt that he had been deceived. One would guess that Mr. Ross's advisors, including his AXA representative, were embarrassed by not being aware of AXA's actions in response to the two trends of long low interest rates and increasing reserve requirements that is, the use of captive reinsurance and shadow insurance. Recently AXA has taken the same steps other life companies have been taking of increasing existing and new life insurance expenses and mortality charges. Advisors need to get re-illustrations on all existing universal life insurance contracts, particularly indexed universal life. The NAIC, the National Association of Insurance Companies, is reigning in the pie-in-the-sky index universal life illustrations with new limitations as to assumptions of returns in illustrations. Even the new limitations are hardly restrictive enough to cause all illustrations to come close to long term economic reality.

So Sid, the bottom line is that the stress of low interest rates and increasing regulatory issues are causing life insurance companies to take actions to lower reserve requirements and increase returns that truly change the landscape of life insurance company risk that advisors need to be aware of.

Sidney Kess: Thank you so much, Ben. Lee Slavutin, do you have any observations on insurance?

New Developments

Lee Slavutin*: Yes, thank you, Sid, there have been a number of developments. Earlier this year, there was another case involving trust-owned life insurance where a trustee was sued for breach of fiduciary responsibility. This was the case of *Rafert v. Meyer* [Neb. Sup. Ct., 290 Neb 219, 859 N.W. 2d 332 (2015)]. In this case, which was very instructive, the trust had a provision that supposedly excused the trustee from his responsibility to pay premiums and to monitor the payment of premiums. After the policies were purchased by the trust, the first premiums were paid, but then subsequent premium notices went to the wrong address. It appears that the trustee gave the insurance companies a false address. I don't know why. The premium notices were not received. The premiums were not paid and the policies lapsed. The beneficiary sued the trustee, and the Nebraska Supreme Court ruled that the trust provision did not relieve the trustee of his liability or his responsibility to properly manage the insurance policy.

This is the third trust-owned life insurance case where there has been an issue regarding fiduciary management of life insurance. The other two cases were *Cochran v. KeyBank* [711 N.E. 2d 1265 (Ind. 1999)] and *French v. Wachovia* [CA-7, 722 F.3d 1079 (2013)]. Those two cases were also instructive because, in both, an independent third party evaluated a life insurance replacement transaction, and the trustees were vindicated.

The second development this year in insurance is a very favorable *Crummey* power case, *I. Mikel* [109 TCM 1355, CCH Dec. 60,277(M), TC Memo. 2015-64], where there were 60 *Crummey* beneficiaries.

I think the important message for all of us with *Crummey* powers, besides the proper requirements for drafting in the trust, is—and this is the headache—to make sure that all the beneficiaries are getting their notices every year. Someone really has to be responsible to make sure that it happens.

The third development is *Our Country Home Enterprises* [145 TC—, No. 1, CCH Dec. 60,344], which deals with a welfare benefit plan, also known as a 419 plan. These plans are designed to obtain an income tax deduction for life insurance premium payments on permanent life insurance where a business enterprise sponsors a welfare benefit plan. The deductions were disallowed, and penalties were imposed.

There have been many cases like this. It's just a reminder that there are really only three ways in which you can safely obtain an income tax deduction for life insurance: the policy is part of a retirement plan or is part of a group-term insurance plan, or the premium is reported as compensation to the employee when it's paid by the employer.

When you start to deviate from those three standard practices, you usually get into trouble, and there have been many cases like *Our Country Home* to show this.

The fourth development involves private placement variable life insurance. This is the *J. Webber* case [144 TC —, No. 17, CCH Dec. 60,336] where a venture capital investor bought a number of offshore private placement life insurance policies. These policies are legitimate. There is nothing wrong with them. It's just that in this case it was abused.

Offshore private placement life policies are policies in which wealthy clients can invest substantial amounts of premium. Usually millions of dollars of premium are invested in these policies. Why? First, there are much lower commissions than with regular life insurance; second, there is no current income tax on the growth of the underlying investment as is true with any cash value life insurance policy; and third, the client can invest in hedge funds that you can't access in a typical life insurance policy.

But, here the client went too far. He indirectly controlled the choice of the investment through his accountant and lawyer. The IRS said, "No, you can't do that." There is a basic doctrine called "investor control," that prohibits the insured client from controlling the investments. The IRS imposed income tax, and also penalties in this particular case.

The fifth development relates to the combination of life insurance planning with other planning techniques, in particular grantor retained annuity trusts (GRATs) and sales to defective grantor trusts. The use of GRATs in life insurance planning is a very powerful tool, for example, when a client sets up a split-dollar life insurance arrangement. Even though the rules changed dramatically in 2003, we are still using split dollar very effectively in certain situations. But, you must have an exit

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strategy from a split-dollar arrangement. And, the most effective exit strategy that I have seen is when you combine split-dollar with a GRAT. You set up the GRAT independently of the split-dollar arrangement. The GRAT terminates in five to 10 years, and the remainder beneficiary of the GRAT is the insurance trust. The insurance trust is then funded with a large amount of money, assuming the GRAT works, and can repay the donor the split-dollar premiums.

Another technique that can be combined with life insurance is the sale to a defective grantor trust. The grantor trust usually has assets generating significant income. The income can be used to pay interest on the note (the grantor trust usually acquires the assets from the grantor with a note) and premiums on life insurance owned by the grantor trust.

For the younger client who needs insurance protection and who wants a conservative savings vehicle, there are several reasons why whole life today is such a valuable product.

Sidney Kess: Lee, could you comment about protecting property from casualties, such as the recently devastating Super Storm Sandy?

Lee Slavutin: Yes. Although I'm not a property casualty insurance broker, I do have a few points I'd like to make about this because we certainly saw tremendous damage from Sandy, especially in New York.

First, a very clear lesson is you must make sure if you have a property near the ocean or bay that you have flood insurance, because the typical homeowner's policy will not cover you for flood damage. You can get flood insurance today. Obviously, it's more expensive, but you can get it.

The second point about property and causality insurance is that it does usually pay with property insurance coverage to have a high deductible. You'll save significant money in premiums. And the deductible, although it's much higher than the normal, is not going to be significant in relation to the value of the property.

The third point on property and casualty insurance is that I think it's very important to make sure our wealthy clients have adequate umbrella liability coverage. You can now easily obtain $10 million of umbrella liability coverage. The premium is very low. It may be less than $1,000 a year for $5 million to $10 million of umbrella liability, but it's well worth it. If the client is sued by a third party for a car accident or someone slips in his home, such a policy will usually cover the liability.

Finally, although you can obtain property and auto insurance directly from certain insurance companies, it is often worth having an independent agent or broker act as your advocate, especially when it comes time for a claim. It's well worth paying an extra 10 percent or 15 percent in premiums to have an agent or broker representing you.

Before we go on to another subject, I think Ben has raised a very important issue about captive reinsurance companies. I would recommend people take a look at *The New York Times* article that was published earlier this year ["Risky Moves in the Game of Life Insurance," *New York Times*, April 12, 2015, p. BU1]. This is a long, very disturbing article on this subject, concerning the risk that some insurance companies are taking. I think it's a very important subject.

And, in response to the increase in cost of some of the non-guaranteed universal life policies that have been sold over the years, I'd like to make a case for whole life insurance for the right client. For the younger client who needs insurance protection and who wants a conservative savings vehicle, there are several reasons why whole life today is such a valuable product.

One, it's sold by mutual life insurance companies (e.g., Guardian, Mass Mutual, New York Life and Northwestern Mutual) that are among the most highly rated, most conservatively managed companies in the country. Although they're not

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all domiciled in New York, they are all licensed in New York, which is by far the toughest regulatory state in the country. The New York insurance department has spoken out vigorously against captive reinsurance.

Another reason that the whole life product today is so suitable for the younger client is that it provides guarantees—guarantees for the premium, guarantees for the death benefit, guarantees for the growth of cash value. And, over the long term, at least 15 to 20 years, it will provide, on a non-guaranteed basis, about a three to four-percent growth rate in the cash value based on the dividends paid by the company. Also, the death benefit will grow over time as dividends are used to buy additional insurance. This can offset the effects of inflation over the client's life.

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Richard Oshins: We do a lot of work with clients who buy the whole life product, often from the carriers that Lee mentioned. These policies have the two primary attributes he alluded to: (1) the death benefit and (2) the tax-free internal growth. A problem that estate planners have been facing for years is that generally the insured client must compromise one of the two benefits. If the client wants to avoid estate tax on the death benefit, then he or she cannot own it at death or have made a gratuitous transfer of the policy within three years of death. In addition, the client cannot retain any rights in the transferred policy or release the rights within three years of death. As a result, the client cannot enjoy the inside build-up without estate tax exposure.

The typical strategy we advise is that all trusts are dynastic and they plan for the acquisition of life insurance on the lives of beneficiaries or anyone else where there is a legitimate insurable interest. My trust is designed to buy life insurance on my children or grandchildren, etc. It, in effect, is a funded irrevocable life insurance trust (ILIT) that achieves both of the primary virtues of cash value life insurance: access to the cash build-up and the death benefit sheltered from the transfer tax system. That increases the benefits of having the policy because it enables an insured/beneficiary to enjoy both of the primary benefits of the policy without sacrificing either. In other words, the policy's value is enhanced. It also achieves another meaningful advantage. Because the trust will generally have cash to fund the policy, that planning will avoid the *Crummey* issues that Lee addressed, and will avoid other funding issues and limitations.

The rules are simple. The insured cannot have any controls or rights over the policy. Thus, someone other than an insured trustee must make all decisions on the policy and the insured as a beneficiary cannot have a power of appointment over the policy or its proceeds. That restriction is of limited constraint. For instance, my child can be the trustee and acquire life insurance on his spouse's life (but not survivorship life), or on the life of any other beneficiary or person for whom the trust has an insurable interest. And, for policies on his life, my child can have firing and replacement rights over the special insurance trustee.

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