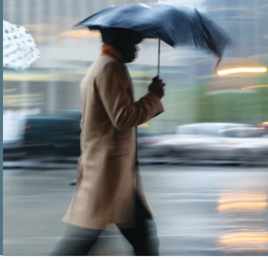


By **Robert W. Finnegan**

Keep, Sell or Surrender?

When your client thinks life insurance coverage is no longer needed

Over time, the law as well as a client's circumstances, goals and objectives change. Often, a client feels that life insurance is no longer needed and considers surrendering the policy for its cash surrender value (CSV). But, is that the right decision? At that time, perhaps the best advice you can give your client is, "Hit the brakes!" Many times, it's not that the client doesn't need insurance, it's that he doesn't like paying for it. Life insurance is an extremely complex financial vehicle that can have an implicit value well in excess of the CSV. The goal for the client's life insurance, legal and tax advisors is to help the client make informed decisions whether to protect, preserve or, if appropriate, harvest that implicit value.

The important takeaway is that there's a process for evaluating existing life insurance coverage. The following comments are intended to provide the advisor with a process to review and evaluate existing coverage. The factors discussed below are interrelated with many different entry points to the process. This is just one way of approaching the subject.

Keep the Coverage?

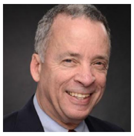
Even if your client intends to retain the coverage, it's highly recommended that you and your client conduct a policy review every two or three years. Insurance isn't a "put in the drawer and forget about it" investment. Yet, that's what many, if not most, policyowners do. The policy review is also a good starting point to address the following important factors that will help determine whether to keep the coverage:

- The insurance need
- Adequacy of coverage
- Affordability
- Policy performance
- Policy as an investment
- Carrier strength
- Owner and beneficiary
- Change of owner considerations

The first and most important aspect of the review is to determine whether there's a current or future need for the insurance, one that may be different than the original need. This need becomes the central pillar of the review around which the other factors are evaluated. If there's no current or expected need for the coverage, you and your client should consider whether to surrender the policy, sell it on the secondary (life settlement) market or donate it to a charity.

The insurance need. What was the original need met by the life insurance, and is that need still valid? The insurance may have been purchased by adult children or an irrevocable life insurance trust (ILIT) for their benefit to pay estate taxes. Frequently, with the high current gift, estate and generation-skipping transfer tax exemptions, the client may feel that the life insurance in an ILIT is no longer needed. But, keep in mind that these high exemptions sunset in 2026, and the Democrats have consistently lobbied for a $3.5 million exemption ($7 million for married couples). The question to consider is whether the coverage is needed based on the lowest exemption scenario. Even then, if the client no longer expects a federal estate tax liability, there may be a state estate tax liability, and reducing the face amount to meet that liability may prove attractive.

The current need may be to supplement the client's own financial security, for example, in retirement. Assuming the policy isn't a modified endowment



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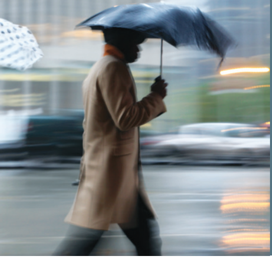


contract (MEC), is it better to take tax-free distributions from the policy or implement a tax-free Internal Revenue Code Section 1035 exchange into an annuity? In addition to providing income protection, the death benefit may still be retained to retire debt, support a surviving spouse or for wealth creation. Clients frequently feel that their children are financially secure, but they may want to provide a legacy for grandchildren. If an annuity is indicated, taking into account the client's retirement needs and other investments, the annuity could be immediate or deferred, fixed, variable or indexed.

If the client is still insurable, it's also important to establish that it's still the right type of coverage to meet the established need.

When the family owns a closely held business that will be passed on to one or more children, the life insurance may be used to equalize the estate by providing a benefit to the children who aren't in the business. Alternatively, the insurance may be a source of liquid capital for the business.

Or, suppose that the policy was originally purchased to fund a cross-purchase buy-sell agreement, but the business has been sold and the life insurance transferred to each insured. The client may still have an estate tax liability but, because the business has been converted to cash and marketable securities, he may feel that the estate has the liquid assets to pay the estate tax. But, why pay the estate taxes with the client's best assets, the marketable securities, when the existing life insurance may pay or at least offset that liability?

Finally, depending on the insured's health, the policy's greatest value and use may simply be in retaining it as an investment (discussed below).

Adequacy of coverage. Is the current amount of coverage adequate to meet the client's needs? More insurance coverage may be called for. But, is additional coverage available and at what price? Does the client own term insurance that's still convertible without evidence of insurability?

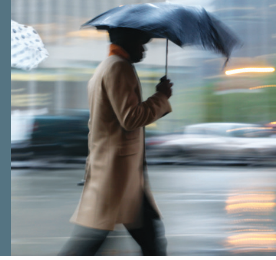
If a lower amount of insurance will meet the client's needs, can the death benefit be reduced so that no further premiums are required? That is, are policy cash values sufficient to carry the policy? If a lower death benefit is called for, is the policy overfunded, and can policy cash values be withdrawn or borrowed while still maintaining the desired death benefit?

A face reduction can cause unexpected tax consequences. For example, if the death benefit is reduced for a single life policy within the first seven years (or the seven years following a material change) or for a survivorship policy at any time, the policy will have to be retested under the MEC rules of IRC Section 7702A and may become a MEC. If the policy becomes a MEC, policy distributions that occur during the contract year of the benefit reduction and thereafter or that were taken in anticipation of the benefit reduction, whether by loan or a partial surrender, will be taxable to the extent of gain in the policy.

For all universal life policies (including indexed and variable universal life) qualifying as life insurance under the guideline premium test, if the policy death benefit is reduced at any time, cash may be forced out of the policy so that the policy continues to meet the definition of life insurance. As a word of caution, the forceout distribution may be taxable if the death benefit reduction causes the policy to become a MEC or if the reduction happens in the first 15 years and results in a forceout.[1]

If the client is still insurable, it's also important to establish that it's still the right type of coverage to meet the established need. For example, survivorship may be more cost effective than a single life policy; term insurance may be a band-aid for a permanent need; or a variable or indexed universal life may provide unnecessary market risk for an older client when a guaranteed policy is called for.

Affordability. Affordability of the coverage can be equally as important as establishing the need for the insurance and determining whether the existing coverage is adequate to meet the client's current needs. If the ongoing premiums are unaffordable, reducing the death benefit so that no further premiums are due may be an



attractive option. If the client needs the cash tied up in the policy and the client's circumstances are unlikely to change, it may be possible to take cash out of the policy while maintaining coverage.

Policy performance. Whether or not there's an established need for the insurance, you should evaluate the policy performance to date. If the client is in good health and is intent on terminating the coverage, then the full evaluation steps (and the discussion below relative to a change of owner and transfer considerations) can be skipped. However, I don't recommend skipping these steps. If the surrender or sale of the policy is being considered, it's important to at least know the amount of taxable gains and cost basis of the policy. Even if it's determined that there's no ongoing need for the coverage, if the client has significant health issues, then the full evaluation is strongly recommended.

The policy evaluation requires obtaining a premium history, in-force ledger illustrations and the taxable gains calculation (including the cash value, CSV, cost basis and the balance of any outstanding policy loans) from the carrier. The in-force ledger illustrations help answer the following questions:

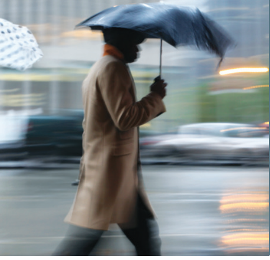
- How has the policy performed based on original premium funding?
- How can it be expected to perform in the future? Based on the original funding, is it on track, over or underfunded? Considering the health of the insured and other factors, does the policy require additional premiums to maintain the required death benefit for the duration appropriate to the need?
- Does the policy have excess CSV? Can some of that cash be withdrawn without jeopardizing the death benefit? Is the policy a MEC so that distributions would be taxable to the extent of gains in the contract? Would there be taxable gains on surrender?
- Is there a large outstanding policy loan, and would phantom income be recognized on surrender?

For example, assume that the cost basis in the policy is $200,000, the amount realized on surrender is $500,000, comprised of an outstanding policy loan equal to $450,000 plus the net CSV of $50,000. On surrender, the client would recognize $300,000 of taxable gains. At a 45% tax rate, the client would owe taxes of $135,000 while only receiving $50,000 of net CSV for a net out-of-pocket outlay of $85,000.

Policy as an investment. As mentioned above, depending on the insured's health, the policy's greatest value and use may be retaining it as an investment. If an insured's health is such that the policy qualifies for a life settlement offer that's meaningfully greater than the policy CSV, careful consideration should be given to keeping the policy. Life settlement investors will frequently want a rate of return on their investment in the neighborhood of 15%. It's therefore important to keep in mind that investors are buying a policy for profit. Therefore, from a purely financial perspective, the coverage is worth keeping. In addition, whereas a life settlement investor will have to pay tax on the death benefit gains, the existing policy owner generally won't (see discussion of transfer for value, below). As a result, the existing policy owner will have a lower hurdle rate for deciding whether to keep the policy. For more information on life settlements, see "Life Insurance Triage Tips for Fiduciaries," in this issue, p. 15.

Even if it's determined that there's no ongoing need for coverage, if the client has significant health issues, then the full evaluation is strongly recommended.

Carrier strength. It's important to assess the carrier's financial strength and claims-paying ability. Although there's some overlap, the different ratings agencies measure different characteristics and weight various financial factors differently. As a result, they compliment rather than duplicate each other. A qualified insurance professional will have access to carrier financial data, and there are a number of tools available to review and summarize such data and compare ratings from the major ratings agencies.



Owner and beneficiary. Are the owner and beneficiary correctly titled to conform to the current need? For example, the life insurance may be owned by the insured when it should be in an irrevocable trust for children and future generations. Or, it may be in a trust for children only (for example, a remainder trust following a grantor retained annuity trust or a charitable lead annuity trust) when it would be more effective in a dynasty trust. Likewise, the policy may be in an irrevocable trust, and the insured doesn't have current or projected estate tax exposure and may want to reacquire the policy (for example, to access the policy CSV).

Establishing the value of a life insurance policy is an extremely complicated subject.

Does the trust allow distributions to the insured's spouse or adult children, and what are the ramifications of the children gifting the policy back to the insured? Could the client purchase the policy with a note with interest capitalized? The business may be the owner and beneficiary of a policy needed for a cross-purchase buy-sell or vice versa.

Change of owner considerations. When changing the owner, there are three important issues to consider:

1. Will taxable gains be triggered on the change of owner?
2. Post-transfer, will the policy be subject to the 3-year rule?
3. Will the transfer violate the transfer-for-value rule?

For example, say a client is currently the equal co-owner with two other unrelated individuals of a business operated and taxed as a partnership, who are in the process of selling the business. Each owner personally owns permanent cash value life insurance on the other two partners to fund a cross-purchase buy-sell agreement. Being close in age and health when the policies were issued and with equal face amounts, the partners have agreed to simply swap policies. Your client would like his policy to end up in an irrevocable trust for the benefit of his spouse and heirs.

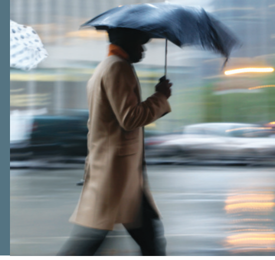
In exchanging policies, the owners are treated as if they sold the policies to each other, and gain will be recognized to the extent that the fair market value (FMV) of the policies exceeds the owner's cost basis.[2]

Once the insured owns the policy insuring his own life, it could be gifted to adult children or to an irrevocable trust for their benefit. The 3-year and transfer-for-value rules must be considered:

- **The 3-year rule.** IRC Section 2035 provides that the value of the gross estate includes property transferred by the decedent during the three years prior to the decedent's death, if the value of such property would have been included in the decedent's gross estate under IRC Sections 2036, 2037, 2038 or 2042. The 3-year rule does "not apply to any bona fide sale for an adequate and full consideration in money or money's worth."[3]
- **Transfer-for-value rule.** IRC Section 101 provides the general rule that life insurance death benefit is income tax free. The transfer-for-value rule is an exception to the general rule and, if violated, the policy death benefit loses its income tax-free character.

The subsequent gift to adult children or an irrevocable trust for their benefit would be: (1) subject to the 3-year rule and includible in the insured's estate if he dies within three years of the transfer; and (2) within the basis exception to the transfer-for-value rule. A sale of the policy for FMV to a trust that's a defective grantor trust (with respect to the insured) may be a better solution because the 3-year rule does "not apply to any bona fide sale for an adequate and full consideration in money or money's worth," and the sale to the defective grantor trust is within the "sale to the insured" exception to the transfer-for-value rule. Establishing the FMV of the policy (the sales price) is critical to avoid a part gift/part sale transaction and to fully meet the bona fide sale exception to the 3-year rule.

Establishing the value of a life insurance policy is an extremely complicated subject. Usually, advisors rely on the Form 712 value as reported by the insurance carrier.



In many cases, those values are extremely high (especially in the case of term insurance policies). Frequently, it's advisable not to request the Form 712 but rather to ask the carrier to provide the value it would report on the Form 712. On the other hand, if the client's health has worsened, the policy may be significantly more valuable than the Form 712 value indicates. At any rate, in the case of a sale of the policy to avoid the 3-year rule, care must be taken to ensure that the "bona fide sale for an adequate and full consideration" requirement is met, and a qualified appraisal of the policy may be indicated.

Regarding the transfer-for-value rule, in response to the Tax Cuts and Jobs Act of 2017, IRC Section 101 and related regulations were recently revised. Although most common exceptions to the transfer-for-value rule generally remain intact (including transfers by gift to the insured, to a partner of the insured or to a corporation in which the insured is an officer or a shareholder), the new rules introduce a labyrinth of complex and potentially draconian traps for the unwary. In particular, if a prior transfer in a string of transfers was a "reportable policy sale," the subsequent transfer, even if within one of the exceptions noted in the parenthetical, may now violate the rule.

Surrender, Sell or Donate?

It's determined that there's no current or future need for the coverage and, based on the advice of his planning team, the client has decided to terminate the coverage. How should he proceed?

First, it's important to review the client's health. If he's in good health, surrender may be advisable. The path forward becomes more complicated if he has significant health impairments.

Policy surrender is permanent, and although there may be a reinstatement right, the time for exercise of that right may be limited, and it may require evidence of insurability. If the client's health has changed for the worse, reinstated coverage may be more expensive or simply not available at all. Such clients, generally age 60 and above who are determined to surrender the coverage, should consider a life settlement. A life settlement is the sale of the policy to investors on the secondary market. Frequently, investors will offer to purchase the policy for an amount that's substantially greater than the CSV.

Most term insurance policies are convertible to permanent coverage without evidence of insurability typically to age 70. If the client was rated preferred at issue, the policy owner may have the right to convert to permanent coverage at the client's attained age, but still at preferred rates—regardless of the client's health at the time. As a result, that term insurance policy may have substantial value as an asset or on the life settlement market. Again, the life insurance policy may be one of the best investments the client ever made (or retained). It's important to note that some carriers only allow conversion to very expensive policies. Prior to conversion, it's therefore advisable to explore whether, based on full medical underwriting, new and more competitive coverage is available. Even assuming the client is still in good health, the existing policy may be more competitive than anything available on the market today. Over the last 20 or so years, carrier investment returns have steadily declined, resulting in higher premiums. Older policies, especially fully guaranteed policies, may be much more competitively priced than any product available today. On the other hand, carriers have reduced expenses and made other adjustments to keep products competitive.

If the client is charitably inclined, donating the policy to a charity may be an attractive option. The amount of the deduction depends on the type of property contributed (cash, long- or short-term capital gains or ordinary income property) and whether the

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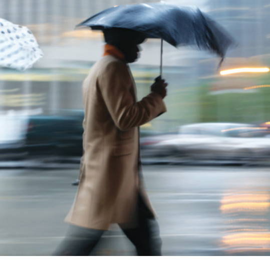


donation is to a public charity or private foundation (PF). The deduction is a percentage of the donor's contribution base (basically adjusted gross income). For example, the deductible amount for the donation of a life insurance policy to a qualified charity is the lesser of FMV or cost basis. In a given year, if the contribution is to a public charity, the donor may deduct 50% of his contribution base; if the donation is to a PF, the donor may deduct 30% of his contribution base. To the extent that the full amount isn't deductible in the current year, unused deductions may be carried forward for five additional years.

Insurance Advisor's Role

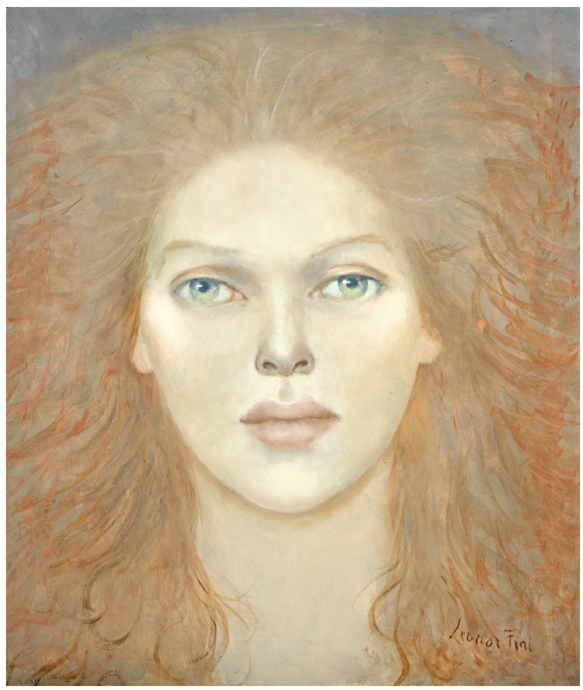
If the client doesn't already have a qualified insurance professional to help him work through the process, it's advisable to team up with one, adding a valuable member to the client's planning team. Working closely with the client's other legal, tax and planning advisors, the insurance advisor can take the client through the policy review process, evaluate the existing coverage and illustrate available options to redesign the policy or reduce the face amount, determine the availability of and place new coverage. He can solicit offers on the life settlement market and help determine the value of the policy in the context of the need for the insurance. The insurance professional can present his process and recommendations to the client's other advisors to ensure that the client makes an informed decision.

Review the Options

The decision to terminate life insurance coverage shouldn't be made lightly. There may be legitimate ongoing needs for the coverage, it may be possible to restructure the policy so that no further premiums are due or it may be possible to access cash while maintaining coverage. If the policy will be terminated, a sale of the policy may produce substantially more cash than surrendering it. It's especially important to review term insurance and the options that it presents. The policy review, conducted by a qualified insurance advisor, is an essential process to help the client consider all of these factors (and more) to make an informed decision to keep, sell or surrender the policy.

Endnotes

1. The "forceout" rules of Internal Revenue Code Section 7702(f)(7) apply to life insurance qualifying under the guideline premium test rules of IRC Section 7702.
2. If the business is a partnership and owns the policies (for an entity redemption buy-sell or keyperson need), the policies can be distributed from the partnership without triggering gain. That's not true with an S or C corporation, in which the corporation will be treated as if it sold the policies. Can the cross-transfer of the policies be characterized as gifts? Possibly, depending on the relationship of the parties (close friends), if the policies are transferred to different parties. For example, Owner A may transfer the policy insuring the client to the client's irrevocable trust, while the client may transfer the policy insuring Owner A to Owner A. It would help support the gift if the policies have different values.
3. IRC Section 2035(d).



SPOT LIGHT

Goddess

Portrait Of Darja Larsen by Leonor Fini sold for GBP 28,750 at Sotheby's Impressionist & Modern Art Day Sale on Feb. 5, 2020 in London. Born in Buenos Aires and raised in Trieste, Italy, Fini became known for her depictions of powerful women. She accomplished her success with no formal artistic training.