

required minimum distributions. She said, "I don't know anything about that. That was written by Employee Plans/Exempt Organizations (EPEO). I only dealt with the QTIP issues."

You can also take that comment in reverse—the EPEO section knows nothing about estate planning and the use of trusts in the estate planning process. I am sure that the author would agree with me that we are both rightfully concerned that the IRS really does not understand some of these issues and, therefore, has to change its views. Otherwise, it can produce some horrendous results. ♦

INSURANCE

Insurance Update

Lee Slavutin, Stephen Krass, William Goldberg, Richard Oshins, and Dave Hirschey discuss tips for purchasing insurance (how much, what type of policy, from which company), the importance of reviewing beneficiary designations, how to fix "broken" life insurance trusts, tax treatment of premiums, and premium financing.

Lee Slavutin: I want to discuss some basic and some not-so-basic points regarding insurance.

The "Right" Amount of Life Insurance. How much life insurance, not for estate planning or business succession purposes, but for protection of the client's income stream if he or she were to die prematurely, is the right amount? For the most part, the people I speak to are not adequately insured. Actually, I am also directing this at the people here in this room, for all of us to take a look at your own insurance coverage. I think that we overestimate the value of \$1 million of life insurance.

One million dollars of life insurance sounds like a lot of money, but it only produces about \$40,000 a year of cash flow if the insurance proceeds are invested in a conservative instrument, such as a tax-free municipal bond. You can say, "I will erode the principal," but when you take into account inflation, that will do it anyway.

Really, the amount of insurance that you need is probably, in many cases, much more than you think. A rule of thumb that I find works, is after you plug in all the assumptions for investment rates of return, inflation, and the duration of the policy, the amount of insurance should be about 20 times after-tax income. For example, if the after-tax income of an individual is \$100,000, that person needs about \$2 million of life insurance to provide that level of income, adjusted for inflation, for 20 or 25 years.

Financial Strength of Insurance Companies. The next point I want to talk about is the financial strength of life insurance companies. First, I recommend *The Insurance Forum* by Joe Belth, former Professor of Insurance at Indiana University, who is one of the great gurus of our industry. If you are active in the insurance area, I cannot recommend this publication highly enough. You can check it out on the internet at www.theinsuranceforum.com. Every year in September, there is a listing of the ratings of all the insurance companies. The first sentence in Belth's publication on financial strength ratings says, "Financial strength is the most important factor a consumer should consider in selecting a company from which to buy insurance." It is not the product. It is not the price. It is the strength of the company. Above all things, you want to make sure that the claim will be paid.

Belth gives a list of the top 75 companies that have the highest ratings from all the different rating agencies. Why would you want to do business with a company outside that top group? There is one situation where you may want to go to a second-tier company—that is where you have a client who has a medical problem and you cannot get reasonably priced insurance from one of the top companies.

The recent events in the news, I think, also accentuate the importance of financial strength. The four hurricanes in Florida and in other states have resulted in approximately \$20 billion of claims. The companies with the largest exposure for homeowners insurance in Florida are State Farm, Allstate, USAA, Nationwide and HDI U. S. Group, according to AM Best. You should check the reports of the rating agencies to determine the impact, if any, of these claims on the insurers.

What is the importance of financial strength of the company, other than the obvious risk that the company could become insolvent? Well, there is another risk, and that is pricing. When a company has a financial problem, the first place that it may look to raise revenue is to increase the premiums of existing policies.

Again, Joe Belth, in the May/June 2004 issue of *The Insurance Forum*, has a chart of what Consecoco has done with some of their universal life policies. He gives an example of a man, 58, who bought a policy in 1987. The insurance mortality charge was \$14 per month, that is, before the cost of insurance was increased by Consecoco. It went up in 2004 to \$91 — from \$14 to \$91! If you want to know why financial strength is important, it is important because it will affect the cost of insurance for the policyholders, not just the risk of not paying claims.

Term Insurance. Many of us buy term insurance and so do our clients. I think you must always remember for yourself and your clients to look at the conversion option, which is the option to convert the policy to permanent insurance without another medical exam. You must make sure that option is there for the duration of the policy. I received a flyer in the mail from a company offering a premium rate much lower than the competitors. When I looked at the fine print, it told me that this is a 30-year term policy, but it only had a conversion option for 10 years. No wonder it is cheaper.

You also want to make sure that the conversion option will allow the client to convert the term policy to any type of permanent insurance. Some companies have restrictions in their contract as to what you can convert to and whether you can convert partially or completely. You need to look at that option. It is very, very important.

Also with regard to term insurance pricing, people who smoke cigars are treated differently. Obviously, if you smoke cigarettes you are a smoker, but if you smoke cigars, different insurance companies treat these people differently. There are companies that will treat an occasional cigar smoker, for example, someone who smokes one cigar a month, as a preferred non-smoker. It is worth looking around for lower rates on people who are smoking cigars.

Long-Term Care Insurance. I am finding that clients, even those with a net worth of \$10 million and up, are buying long-term care insurance. The cost is prohibitive for this type of care. It can cost up to \$100,000 per year in some states and costs are going up. Companies are withdrawing products that they have underpriced. Why have they underpriced them? Most companies have not been offering long-term care policies for very long. Some companies are finding that they have underpriced their products to grab market share.

One thing you can do to reduce the risk of future price increases is to buy a policy with a 10-payment option. That is, a policy where you pay the premiums for 10 years. The guarantee is that there will be no premium payments required after the tenth year, so, at least, that way you eliminate the risk of a price increase beyond the tenth year.

Foreign Travel. About three years ago, most companies completely declined to issue insurance to someone who traveled to Israel or other parts of the Middle East. That is now changing.

Many companies have now loosened their guidelines. Some are now issuing policies to people who do travel

to Israel on a regular basis. It is worth looking around for policies for people traveling to the Middle East. However, the companies generally will not issue term insurance to these clients. It has to be some form of permanent insurance, usually universal life insurance.

Beneficiary Designations. An article appeared in this newsletter on February 19, 2004, "Incomplete Beneficiary Designation Found Valid," that clearly illustrates the problem. The case discussed in this article, *Terry v. Largrois*, CA-6, 354 F3d 527, involved a husband and wife who got divorced and no one paid attention to the fact that the ex-spouse was still the beneficiary of the policy. Although a few states like Texas will not respect such a designation, most states will go by the contract, which means the ex-spouse gets the money. No matter what the children say, the ex-spouse gets the insurance proceeds. If you have divorced clients, make sure that the beneficiary designation of their insurance policies has been updated.

The next point is contingent beneficiary designations. Sometimes people name their minor children as the contingent beneficiary. This is not a good idea. A testamentary trust should be established under the client's will to take care of the children. If the children are minors, they will not get the money outright. They will need to have guardians appointed, if a testamentary trust is not the beneficiary.

Disability Insurance Taxation. The next point is the taxation of disability insurance premiums. This is one of the mistakes that people make again and again. In fact, there was a case in Alabama, in which an accountant got sued by a doctor because the accountant told the doctor, "Pay the premiums with tax deductible dollars." The doctor became disabled and had to pay taxes on the disability benefit. You should not, in general, pay the disability insurance premiums with pre-tax dollars. They should be paid for with after-tax dollars so that the benefit is tax free.

Interestingly, the IRS issued Rev. Rul. 2004-55, IRB 2004-26, 1081, which addresses a very important question. People have often asked, "Could we pay the premiums with employer pre-tax dollars, and if my client gets disabled in September, we could then make an election to have the premium treated as taxable income?" The IRS says no, you must make the election before the plan year begins if you want to have the benefits treated as tax free.

Stephen Krass: Lee, what if you have a disability income plan at the corporation in which the stockholder/employee will pay the premium himself or herself and can request reimbursement from the corporation one

year and one day after the payment of the premium or into the next policy year? Could you then argue that disability insurance is like term insurance, it is only as good as the last premium paid? Therefore, the employee should be credited with paying the premium, and the benefits would then be non-taxable. That is different from the ruling.

Lee Slavutin: In this example, the reimbursement that he gets a year and a day later is treated as what?

Stephen Krass: It is almost like a medical reimbursement plan.

Lee Slavutin: It is not taxable income?

Stephen Krass: Correct.

Lee Slavutin: It sounds like form and substance to me.

Stephen Krass: Well, I like form.

Lee Slavutin: My answer, as you can probably tell, is that I am not comfortable with it. The fact is that people have the money to pay the premiums when they are healthy. When they get sick and they need the disability benefit, I do not want to risk that benefit becoming taxable. My gut reaction is not to do that.

GST Tax. The next thing is the generation-skipping transfer (GST) tax. I cannot emphasize how troublesome this area is. Particularly, the insurance trusts with GST exclusions and exemptions. The accountants are the people who prepare the gift tax return and, therefore, sometimes believe that they should also be completing the section on the GST allocation. They may be asking for trouble unless they really know this area.

For example, some advisors may be under the impression that gifts made to an insurance trust that qualify for the gift tax annual exclusion will also automatically qualify for the GST annual exclusion. The rules for the GST annual exclusion are not the same as the gift tax annual exclusion. For example, to get the GST annual exclusion, the trust beneficiaries must be only skip persons. If a child and a grandchild are the trust beneficiaries, the GST annual exclusion may not be available.

Deductibility of Insurance Premiums. Time and time again our clients get a proposal that says, "We can provide a life insurance policy for you on an income-tax deductible basis." There are only three situations where an income tax deduction can be obtained safely by the corporation for the payment of life insurance

premiums: 1) if the insurance is owned by a pension or retirement plan; 2) if the insurance is in a group term policy, limited to \$50,000 per individual; or 3) if the premium is paid as a bonus to the employee and, therefore, is taxable income to the employee. Other than that, you are in a gray area.

In particular, what I am referring to is the multiple employer welfare benefit trust. This is actually a listed transaction. In IRS Notice 2003-76, IRB 2003-49, 1181, there is a list of tax avoidance transactions. Number two on the list are certain trust arrangements purported to qualify as multiple employer welfare benefit funds. So, you have to be extremely cautious with this type of transaction.

Stephen Krass: That would not include a 419(e) plan, which is the single employer welfare benefit trust.

Lee Slavutin: I do not know about 419(e). The welfare benefit trust is governed by 419A(f)(6). I would stay away from anything that has 419 in front of it that tries to tell me that premiums for a permanent life insurance policy are a tax deductible corporate expense.

William Goldberg: I will mention one other situation where you can get deductibility, and that is where you gift a life insurance policy to fund a charitable bequest or endowment, and it is actually the charity that owns the policy. You are making annual gifts to the charity and the charity then turns around and uses them to fund the premium payment.

Lee Slavutin: That is right. In fact, relating to that point, you have to be careful how that is done. Some people write the check to the insurance company rather than directly to the charity, in which case you do not get the full 50 percent of adjusted gross income (AGI) as the deductible limit. Rather, you go down to 30 percent for a public charitable organization. You really need to write the check, as Bill says, to the charity, and the charity then has the discretion to write the check to the insurance company. That way you get the full 50 percent of AGI limit for your charitable contribution. It may not be an issue for most clients, but sometimes it becomes important.

Insurance Trusts. The next point is on insurance trusts. There was an excellent article by Sebastian Grassi, Jr. on this issue ("Key Issues to Consider When Drafting Life Insurance Trusts," *Estate Planning*, August 2004). He pointed out how important it is to carefully draft the withdrawal rights, the *Crummey* powers. For example, it is important to give the *Crummey* power-holder not just the right to withdraw from the contributions made to the trust, but also from the assets of the trust, includ-

ing the cash value of the (permanent) insurance policies. What if you have a term policy in the trust? You need to then also provide the beneficiary with the right to withdraw a fractional interest in the term policy. I think it is a very important point as to how you draft *Crummey* powers.

Richard Oshins: One error that I see time and time again is in some of the bank forms. The power of withdrawal states that upon receipt of a gift to the trust, the trustee will give notice to the beneficiary, at which time the beneficiary will have a certain amount of time to withdraw. That will not qualify for an annual exclusion gift because there is not the immediate right of withdrawal.

The immediate right of withdrawal should start at the time the contribution to the trust is made, and not from the time of giving notice. However, there are many bank trust forms that have that kind of provision in there. I bet between one-third and one-half of the trusts that we review have that error in it.

Lee Slavutin: Next, the problem I would like to address is what some have called a “broken irrevocable life insurance trust” (ILIT). There are two situations here. One is that a client says that the trust that they created 10 years ago does not have the right provisions. The money goes out too quickly or too soon to the beneficiaries. Second is that an insurance trust contains provisions that would cause estate tax inclusion of the insurance policy proceeds. For example, it requires the trustee to use the proceeds of insurance to pay estate taxes.

One of the ways to solve the problem, assuming you want to keep the insurance policy because it is a good policy, but you do not want to keep it in this bad trust, is to sell the policy from the bad trust to the new trust.

In fact, there were two letter rulings (IRS Letter Rulings 200228019 and 200247006) that say that this will work and it will not be a transfer for value if the second trust is a defective grantor trust.

Split Dollar. Split dollar has been very quiet. The only situation that I can think of where you may want to think about split dollar is a second-to-die policy because it still retains tremendous economic leverage for the gift. I will give you an example. We have clients, in their late 50s, who have \$10 million of second-to-die split dollar insurance. The annual premium on the policy is about \$75,000. The reportable gift last year on that \$75,000 premium, calculated on the joint term rate of the 2001 table, was about \$200! This table can be found at www.tigertables.com.

However, when one spouse dies, the economic benefit cost will jump.

Premium Financing. This has become popular as an alternative to split dollar. First, I would not do it for someone under the age of 70. I think it becomes too long a tail for the build-up of the loan. Second, I would not accrue the interest. I would pay the interest as you go for the same reason. Third, I would design the policy to have an increasing death benefit. I would not use a level death benefit since you may run out of insurance.

Richard Oshins: I think that this is something that concerns me. We see a lot of premium financing. I am very concerned with the gift element that you are typically going to have if the insured/grantor guarantees the loan in the event of a shortfall from the insurance trust. The question of whether or not there is a gift by making the guarantee is passed over much too quickly.

What we have done in our firm is we pay for the guarantee. I am just really concerned that there is a gift by making the guarantee. I have seen two opinion letters, one by Larry Brody and the other by Frank Mirabello, that basically say “The better argument is,” but they are not definitive, and they back off towards the end. There are also a number of books and articles that express the same concern. I just think that the insurance industry is just looking the other way a little too often.

Stephen Krass: Sid, I would like to direct this to Dave. How comfortable would you be selling a policy from trust A to trust B, which has different provisions for the children and for the grandchildren?

David Hirschey: The trustees have a fiduciary issue. Is the sale of the policy in the best interests of the beneficiaries of Trust A? I assume that Trust A does not have a trust protector who has the power to direct the trustee to make the sale.

Richard Oshins: One of the things that we will do, in some cases, to save the fiduciary, is have the grantor write a letter indicating that he or she believes the fiduciary should sell the policy. Also, indicating that there will no longer be any cash contributions for the premium payments, therefore putting the fiduciary in the spot where selling is a more prudent decision.

Lee Slavutin: *Buy-Sell Agreements.* These are the two final points that I think are very important. One is I think that you should take a look, if you have not already, at the *Blount* case (*G. Blount Est.*, 87 TCM 1303, CCH Dec. 55,566(M), TC Memo. 2004-116). It was a disturbing decision on a buy-sell redemption agreement where the

IRS added the value of the insurance proceeds to the redeeming shares of the corporation. Further, the court did not buy the argument of reducing the value of the corporate stock because of the obligation the company had to redeem the stock with the insurance proceeds. I do not know what the answer is, but you need to be aware of that decision if you are doing redemption buy-sell agreements.

Asset Protection. The last thing I wanted to mention is on September 21, 2004, in the *New York Law Journal*, there was a really interesting article on a structured settlement case ("Exemptions for Personal Injury Settlements," by Robert L. Pryor). A person got injured and an annuity was purchased from an insurance company as a way of settling the obligation. The annuity was exempt from the creditors in a subsequent bankruptcy proceeding (*In re Richard K. Stahlman et al.*, Case No. 01-82000-478 (Bankr. EDNY 2001)).

There was a very interesting discussion in that article. The author suggested that the annuity may not have to be a commercial annuity. A private annuity might also be exempt from bankruptcy creditors. ♦

Guaranteed Universal Life Insurance

Ben Baldwin III and Lee Slavutin discuss guaranteed universal life insurance, how to choose a policy, and the risks of using these policies in planning.

Ben Baldwin III: Guaranteed death benefit universal life, or universal life with secondary guarantees, is becoming an issue of substantial discussion in the industry essentially because it is very, and some believe too, cheap. The product design circumvents the National Association of Insurance Commissioners (NAIC) Regulation XXX regarding raised reserve requirements for insurance carriers on long, level premium contracts and 30-year and out level term contracts. The reason it is believed that these products circumvent Regulation XXX is that these universal life contracts are often sold assuming a \$0.00 cash surrender value at older ages, and yet the policies, being "permanent" contracts, are not subject to the higher reserve requirements to which term contracts offering the same guarantee would be subject. Insurance advisors started selling minimally funded universal life policies, making them look like level term contracts. NAIC tried to curb this circumvention of Regulation XXX with Regulation AXXX.

Insurance companies have also found methods to skirt Regulation AXXX and have used them to reduce what they feel are their reserve requirements. The insurance company interpretation has allowed companies to issue low guaranteed premium universal life policies. So low, in fact, that some insurance companies and a number of industry analysts feel that the policies and/or the

companies writing them may not be able to actually meet their promised obligations.

A 65-year-old can pay close to \$20,000 a year for \$1 million of coverage and have a guaranteed death benefit. My calculator tells me that it takes more than 20 years at just seven percent to accumulate \$1 million. It does not seem to take much for this policy to be unprofitable to the insurance company.

Five to 10 years out after issuance of the policies, Regulation AXXX substantially increases the reserve requirements for these contracts. Moody's, Fitch, and AM Best have all estimated between \$50 and \$100 billion in additional reserves will be required. If we have a low-interest rate environment, if we have a reduced availability of reinsurance or an increased cost of reinsurance or letters of credit, we could see dramatic negative effects on companies that have issued large amounts of this kind of insurance.

From the fiduciary's standpoint, from the advisor's standpoint, these policies have been very popular, especially for estate planning situations, because of the guaranteed death benefit and the liability is laid off on somebody else for providing the death benefit. Uncertainty for the long-term costs of the coverage seem to have been removed by the guaranteed premium provision. You no longer need to be concerned about the asset growth. You no longer need to be concerned about asset allocation and investment research. You are left only with the monolithic risk that one carrier will survive many years into the future and still be able to meet the guarantee. You are left with the additional risk that analysts, such as Moody's, Fitch, S & P and Joseph Belth of *The Insurance Forum*, will publish their concerns about these products and their impact on writing companies.

Articles that have come out this year have been vocal in their statements that they do not feel that this is a healthy way to run an insurance company. They feel that it is going to hurt the solvency of numerous insurers and that most have used aggressive assumptions in numerous aspects of policy design.

According to Joe Belth, the financial strength of the insurance company is the primary factor in choosing a policy. He also says integrity is one of the factors when you are looking at the strength of the company. I would add another factor, size. Is the company large and diverse enough to absorb mistakes and still survive?

When you get aggressive assumptions on policies and their performance, you get very little margin of error, and you create additional regulatory risks. Executive Life was brought under, at least, in large part, if not in large measure, by regulatory risk. Regulators forced Executive Life to change its investment strategies and