

to become a big ruling in the next six to 18 months once we get our arms around it.

Pension Protection Act

I want to summarize a couple of comments about the Pension Protection Act. Under the Act, when you execute a new deferred compensation plan, you are going to have to test to make sure that your defined benefit plans are properly funded. That is Section 116 of the Pension Protection Act. I think this is very interesting in that the individuals—the lawyers and CPAs who are designing these deferred compensation plans—have very little knowledge about those actuarial calculations, so the opinion of an actuary regarding whether the compensation plan is properly funded will be required.

Moving on to the issue of interest rate assumptions, Section 302 of the Pension Protection Act may result in a time when people will retire either earlier or later depending on where interest rates are going. This is a change as we go to more short-term rates. Another big development of the Pension Protection Act is that we are now permitted to have direct rollovers from retirement plans to Roth IRAs. We are permitted to take money right out of an ERISA plan and transfer it into a Roth IRA, which makes the process much easier. If I have retirement money in an ERISA plan and I die, and my IRAs or my qualified plan is payable to a trust, we can move that money into an IRA and have that IRA payable to a trust.

My advice for physicians who are in practice by themselves or in small groups will be not to roll money into IRAs anymore, but to potentially leave it in the plan at their clinic, if that plan survived, until they are well beyond their malpractice statute of limitations. In the ERISA plan, the funds are protected. It is rock-solid. Once the funds are rolled over to an IRA, they are subject to state law and, depending on what state they live in, there may be some exposure.

The rollover IRA is fully protected if you are in a bankruptcy. But what I am told by the litigation attorneys is that they would like to see the money in a qualified plan where it is protected, bankruptcy or no bankruptcy, because it gives them more leverage in settling these cases.

Sidney Kess: Are there any other questions on the Pension Act?

David Hirschey: It is getting easier for a high-income client to take a traditional IRA and convert it to a Roth IRA. Steve, have you seen more of this? It is beneficial from an estate tax viewpoint. When income tax is paid on the conversion, the money used to pay the income tax is not subject

to estate tax at the parent's death. A child would prefer to inherit a Roth IRA rather than a traditional IRA.

Stephen Krass: I find that such advice comes more from the financial planners and the accountants than from the estate tax attorneys. We learn about it after. Generally, I am not in that loop. When a client comes in to review the estate plan now and I see there is a Roth IRA, I know what has happened, but I was not consulted. The financial planner and the accountant have generally given this type of advice or have discussed this with a client.

David Hirschey: For a client who is dying, would it make sense to do the conversion to a Roth IRA if the client will be subject to estate tax at death?

Stephen Krass: Yes.

Robert Keebler: David, there is very little risk to do a Roth conversion for someone who is dying because, under the recharacterization rules, a personal representative or an executor can recharacterize. I encountered a situation a couple of weeks ago, and the client wanted me to run all kinds of numbers. The man was on his deathbed. I said, "Just convert and we will run the numbers later and figure out where we are." So you are exactly right.

The other thing on Roth conversions is that under the Tax Increase Prevention and Reconciliation Act (TIPRA) (P.L. 109-22) beginning in 2010, the \$100,000 income limitation will be gone. So, it will open the floodgates to convert. I think what we will see in the fall of 2009 is virtually everyone we represent asking whether they should convert to a Roth IRA. ♦

INSURANCE PLANNING

Latest Insurance Trends

Lee Slavutin, Ben Baldwin, Jr., Wallace Head, Robert Keebler, Richard Oshins, and David Hirschey on life insurance industry trends and developments.

Lee Slavutin: I am going to be discussing trends in the life insurance industry.

Financial Strength of Insurers

First is the financial strength of insurance companies. This is the most important factor that one should consider before buying an insurance policy from any company. Every year, at the time we have this meeting (September), Joe Belth issues *The Insurance Forum* (www.theinsuranceforum.com), which lists the top-rated companies. For 2006, there are 43 life-health insurance companies in his top group. These companies are regarded by "extremely conserva-

tive criteria” as companies with “high ratings.” Belth’s second best group has 86 companies. In general, I would recommend not going outside Belth’s top two groups to purchase life insurance, unless you had a good reason, such as the insured individual having some difficulty obtaining insurance for medical reasons.

Foreign Travel

Foreign travel has become an issue over the last five years in the wake of the September 11, 2001 tragedy, particularly with respect to travel to certain countries, such as Israel, India, and some countries in South America. It has become difficult for people who travel frequently to those countries to get life insurance. I have one client who was flatly declined insurance simply because he travels to Israel on a regular basis.

Three states—Florida, California, Washington, and there may be more—have now prohibited the use of travel history in underwriting a life insurance policy. We were able to make use of this change a few months ago for a client who travels to Israel frequently and who also has connections to Florida. Someone who lives in Florida is one of the trustees of his insurance trust. The application was signed in Florida and because it was a Florida application, any question regarding travel could not be used in underwriting the insurance. As a result, this client, who goes to Israel eight or ten times a year, got a standard insurance policy. This is a strategy that you may want to use if you have clients who do a lot of overseas travel.

Investor-owned Life Insurance

Investor-owned life insurance (IOLI) is probably the most talked-about subject in the life insurance industry today. In this transaction, insurance is being purchased on the life of an older person, typically someone in their 70s or 80s, and the policy is not being purchased for one of the typical reasons that the family may need insurance, but rather for a speculative element. Premiums are financed by a bank or some other institution and interest is accrued on the loan. The assumption is that after two years, or perhaps a little longer, from the time the policy is purchased, the policy will be sold in the settlement market. The sale proceeds will pay off the loan and a profit will be generated and part of that profit might come back to the insurance trust or to the client.

Such transactions have generated a lot of scrutiny, both from the insurance companies and the regulators. For example, New York Life has just initiated an action against a particular client to rescind a policy that was issued on this basis.

Clients typically will want to know, “What’s my downside? I’m just going to sign the application, and someone

else is going to buy the policy. I don’t even have to pay for it.” Well, one of the downsides is that, in some of these transactions, the client, whether he or she knows it, is taking on a liability. If there is a material misrepresentation on the insurance application and that person dies and the claim is not paid by the insurance company because it was not told that this was an investor-initiated transaction, the insured may have an indemnification liability to the investors.

That is a large open-ended liability because we are referring to relatively large policies. The problem is that, in some cases, the questions on the insurance application are not being answered accurately. There are usually specific questions on the application asking if the premiums are being financed, or if the policy will be sold or is intended to be sold. And, if the client is unaware that these questions are not being answered accurately, that client may have a liability down the road if the claim is not paid.

Most of the major life insurance companies have now told agents and brokers that they will not issue a policy if it is part of an IOLI transaction. If you have a client who is contemplating such a transaction, someone needs to scrutinize the insurance application and make sure that the questions are being answered properly.

Life Settlements

Life settlements should be distinguished from investor-owned life insurance. Here, I am referring to “vanilla life settlements.” These are straightforward settlement transactions in which a client, for whatever reason, has a life insurance policy that they no longer want to maintain. Maybe, the client owned a lot of real estate and then sold the real estate, so the estate liquidity issue is no longer present. Perhaps, the individual was a key person at a large company. The company owned an insurance policy on that person’s life, that person is about to retire, and the policy is no longer needed.

There are many situations where people have insurance policies and there is no longer a reason to keep them, and, normally, they would just cancel them. These clients should consider a life settlement, especially for term insurance policies, because when you cancel a term insurance policy there is no value that you receive for it. However, if you sell the policy, you may get something substantial.

Today, for people over the age of 70, the average sales price of a policy sold in the settlement market is about 20 to 25 percent of the face amount. In other words, if I have a policy with a death benefit of \$1 million, on average those policies that are sold will yield a sales price of \$200,000 to \$250,000 for a \$1 million death benefit. That is a nice sum of money that the client might otherwise not have received

if they had just canceled the policy. Obviously, there are tax consequences. Some of that money will be taxable and some of it will be a return of the original investment.

Life settlements are growing very quickly. Transactions have been growing at 43 percent annually over the last four years. Clearly, this is now becoming a commonplace transaction. It will get more and more regulated, but I think it is legitimate, it is valid, and I think it should be used in the right client situation without any hesitation.

The National Association of Securities Dealers (NASD) has issued a notice to members that when doing a settlement involving a variable life policy, it is necessary to adhere to the usual due diligence and suitability requirements that would apply in any securities transaction.

The subject of life settlements was extensively reviewed in *ESTATE PLANNING REVIEW*, May 23, 2006, p. 33—a very good review of the whole subject.

Just recently, Eliot Spitzer, Attorney General in New York, initiated a lawsuit against Coventry First, a major buyer of life insurance policies in the settlement market. The complaint alleges that Coventry engaged in bid-rigging and unfairly reduced the amounts owners received for policies (www.oag.state.ny.us/press/2006/oct/oct26a_06.html). The lawsuit highlights the need for due diligence on the life settlement broker, who should be conducting a legitimate auction for the best bid. The life settlement broker is the intermediary between the client's insurance broker and the institutional buyers of the policies.

Insurable Interest

The insurable interest issue was raised by the *Chawla* case (*Chawla v. Transamerica Occidental Life Insurance Company*, Docket No. 03-1215, February 3, 2005, aff'd in part and vac'd in part, CA-4, 440 F.3d 639). In response, the state of Maryland has made it clear that an insurance trust does have an insurable interest in the insured. I believe that this case has been given too much attention. It is, I think, of little practical importance. I do not think that any insurance company would ordinarily try to challenge the insurable interest of an insurance trust. The only reason this occurred in *Chawla* is that TransAmerica was determined to deny the claim. The insured lied several times in completing the application, did not disclose significant health issues, and, consequently, TransAmerica used every reason they could think of to deny the claim and it was successful in denying the claim, but not on the basis of insurable interest.

Maryland, Delaware, and Connecticut now specifically say that an insurance trust will have an insurable interest. Other states will look through the trust to see

who the beneficiaries are. But, as I said before, from a practical point of view, this issue will probably rarely, if ever, come up. I do not think it is something that one ordinarily needs to worry about.

Pension Protection Act

The Pension Protection Act of 2006 (P.L. 109-280) added new Code Sec. 101(j), which provides that entities with a business-owned life insurance policy issued after August 17, 2006, must fulfill certain notice and consent requirements. In essence, they have to tell the employee that they are insuring his or her life and the employee has to agree to it. No longer is it allowed, as was done by some very large companies over the last few years, to purchase hundreds of policies on employees and not inform the employees.

However, other than this notice and consent requirement, there is no problem with key person or buy/sell insurance. It is just added paperwork that will have to be filled out to make sure companies are in compliance.

Life Insurance in Qualified Retirement Plans

The Department of Labor (DOL) issued an advisory opinion stating that it was perfectly acceptable to sell a second-to-die policy from a profit-sharing plan to some outside party. This is not new. This particular exemption has been around for many years, starting in 1977, I believe, and then it was revised in 1992. The good news is that the DOL has no problem with second-to-die, as opposed to individual life, policies being sold by a plan to an outside party.

I am going to move on now to valuation of life insurance policies sold or distributed by retirement plans. This was a big issue because people would buy a policy, spend \$100,000 a year in premiums, for example, and after five years and \$500,000 in premiums, the retirement plan would sell the policy for "15 cents," or some equally ridiculous figure, to an insurance trust. The IRS came out with Rev. Proc. 2005-25, 2005-1 CB 962, and introduced new valuation rules to eliminate this abuse. However, even with the new guidelines under what is called the PERC valuation method (premiums minus expenses and reasonable changes), there is still an opportunity to get some discount on the valuation. In other words, if you spend \$500,000 in premiums, you may be able to get a 20-to 25-percent discount off that number in terms of the value of that policy for sale purposes. So, although it limits the technique of what used to be called "pension rescue," it may be a viable strategy in some cases.

Robert Keebler: Lee, with respect to your point about the PERC rules. This technique ended when the IRS basically

crushed it after we went from your hypothetical \$500,000 investment and it became 15 cents when it came out. The IRS said that did not work. With provisions of the Pension Act providing the ability to keep money in a pension plan longer and still get a stretchout by virtue of being able to transfer that to an IRA, there is probably going to be a planning technique where people buy the insurance in the qualified plan again, maybe even keep it in there until they die, and then move all that to an IRA.

Fully Insured 412(i) Plans

Lee Slavutin: A “vanilla 412(i) plan” is a fully insured defined benefit plan in which the plan assets are completely invested in life insurance and annuity policies, or just annuities, and is perfectly legitimate. In abusive 412(i) plans, excessive amounts of life insurance are being purchased on a discriminatory basis.

In one instance, a doctor is suing a life insurance company because his 412(i) plan got into trouble. You should know that an abusive 412(i) plan is now regarded as a listed tax avoidance transaction that has to be reported.

The “Sub-trust” Technique

I recently received a copy of a technical advice memorandum (TAM) dealing with a sub-trust in a pension plan. This has been a subject that has received a lot of attention over the years, and people have argued back and forth whether or not it is viable. There have been arguments pro and con, but we never had a ruling from the IRS on whether a sub-trust worked.

A sub-trust is really an irrevocable life insurance trust (ILIT) created within a pension trust. It is a trust within a trust and the sub-trust owns a life insurance policy. The sub-trust concept was promoted on the basis that someone could buy a life insurance policy in a pension plan with tax-deductible dollars and—this is the particular advantage behind the sub-trust—could also exclude the insurance policy from the estate of the insured participant, which everybody thought, if it works, would be fantastic. No income tax on the premium and the death benefit is estate tax free!

There have always been concerns about the strategy, and now, finally, these concerns have been articulated in a TAM, which I believe will be published soon. The TAM concludes that the plan will be disqualified, at least in this particular situation. There are a number of issues, but the clearest one is that, if a life insurance policy has been placed in a sub-trust, it is being walled off from everyone and everything around it, meaning that the insured participant cannot touch the policy. This is why it should work, theoretically, from an estate tax point of view, because the participant has no incidents of ownership.

But, the very feature that proves advantageous for estate tax purposes is a big problem for purposes of the Employee Retirement Income Security Act of 1974 (ERISA), because it now violates one of the fundamental features of a Code Sec. 401 qualified plan, which is that the benefit that is being funded by the insurance policy has nothing to do with retirement benefits. It is not “incidental” to the purpose of the plan. Although the TAM raised other issues, the point is that the risk is a very large one, because the problem is not just an income tax issue on a portion of a contribution or distribution, the real risk is about the whole plan being disqualified.

My impression is that once this ruling becomes generally known, people will stop doing sub-trusts. It is probable that some of the sub-trusts that were done years ago will be grandfathered, but I think new sub-trusts are probably going to be out of the planning arena.

Grantor Trust Status

IRS Field Attorney Advice 20062701F is a private ruling on grantor trust status. It is interesting, because people sometimes assume that, when you have a trust that owns a life insurance policy on the life of the grantor and the trust is permitted to use the income in the trust to buy the insurance and pay the premiums, that is enough to make the insurance trust a defective grantor trust for income tax purposes and to enjoy all the benefits of that particular characterization. That is not true.

There are many practitioners who believe that this provision alone—the provision that allows you to use the income of a trust to buy insurance—is not sufficient to make the entire trust a defective grantor trust for income tax purposes. I would recommend that everyone take a look at this Field Attorney Advice. It was reported recently in Steve Liemberg’s newsletter (<http://www.leimbergservices.com>).

A related issue in that if you have a defective grantor trust with *Crummey* powers, you may get into trouble. It is basically the opposite problem, because when you have the *Crummey* power, you may give the *Crummey* power holder a right to withdraw a particular portion of the trust which might spoil the defective grantor trust for the grantor of the trust. Just another point to be aware of when you are doing planning with insurance and grantor trusts.

Richard Oshins: I have a question I would like to ask on that issue. Wouldn’t the grantor trust rules trump the *Crummey* rules and it would, thus, be a grantor trust for income tax purposes? For example, if I had my sister as the trustee, I am taxed on the income, and the *Crummey* powers should be irrelevant during my lifetime.

Lee Slavutin: I am not sure what the answer is, whether it does trump it, Dick. My understanding is that, if a *Crummey* power holder has a right to the assets under the trust pursuant to the power of withdrawal, it might spoil the grantor trust status. But, I am not sure. Does anybody else have an idea?

Robert Keebler: I wrote that up recently for my Family Tax Planning Forum column for TAXES—THE TAX MAGAZINE, June 2006, “*Crummey* Powers in an IDGT—LTR 200603040.” I believe how that ruling came down is that Dick is right, the power under Code Secs. 671 through 678 trumps the power of the *Crummey* withdrawal.

Richard Oshins: One comment on that. Here is what I did for my family. I have two children, so I set up two life insurance trusts. They were separate but equal, and the only persons given a power of withdrawal were: (1) my son Steve for the trust set up for my wife and Steve’s side of the family, and (2) my son Jay for the trust set up for my wife and Jay and his descendants. In that way, after my death, I think that it is reasonable to argue that these trusts are income tax defective as to the child who had the power of withdrawal and, therefore my child can buy and sell and transact with the trust income tax free. I am not positive it is right, but I have set up a vehicle that, in case I am right, each child has the ability to deal with his own trust in a manner that they could not deal with it if there was only one trust which happened to split at a certain time.

COLI and Deductibility of General Interest Expense

Lee Slavutin: Corporate owned life insurance (COLI) and interest expense is the subject of a recent private letter ruling (see ESTATE PLANNING REVIEW, September 19, 2006, p. 68). The ruling says, believe it or not, that if a business entity owns life insurance on certain individuals, it is possible that the very existence of that insurance will cause some of the general business interest expense unrelated to insurance to become nondeductible. Let me make sure that everyone is clear on that point. I am referring to the deductibility of general business interest expense, such as the interest that might be incurred on purchasing a piece of equipment and that has nothing to do with insurance policy loans. The existence of an insurance policy owned by the business might cause a partial disallowance.

In practical terms, the only situation I have seen, apart from this very quirky private letter ruling, in which this issue might potentially arise, is with a partnership. In a partnership that has more than five partners and where the partners are insured by life insurance as part of a buy-sell arrangement, for example, and the policies are owned by the partnership, there may be a problem, if the issue is ever picked up by an IRS agent. The reason being

that the exceptions that normally protect one from this problem do not apply to a less than 20-percent owner who is a partner and who is not an employee (partners are not treated as employees) (see Code Sec. 264(f)).

Buy-sell Insurance

The *Blount* case (*G. Blount Est.*, CA-11, 2005-2 USTC ¶60,509, aff’g in part and rev’g and rem’g, 87 TCM 1303, CCH Dec. 55,636(M), TC Memo. 2004-116) got straightened out on appeal. This was a very disturbing case, because it concluded that insurance owned by a corporation as part of a stock redemption buyout would be added to the value of the business, and there would be no offsetting deduction for the liability that the business had to redeem the stock. Thankfully, the U.S. Court of Appeals for the Eleventh Circuit said that was wrong and that there should be a deduction for the liability the corporation had to redeem the stock.

Quarterly and Semi-annual Premiums

An interesting point for our clients, noted again by Joe Belth in the *Insurance Forum*, is how costly it can be if you pay insurance premiums quarterly or semi-annually as opposed to annually.

Ben Baldwin, Jr.: One observation I would make on the fractional premiums is that the result you note is applicable to the fixed premium policy designs and not the universal types.

Life Settlements for Trust-owned Policies

David Hirschey: Lee, I have a question on life settlements. Assume that an irrevocable insurance trust owns the policy and the trust agreement is drafted on the assumption that the policy will mature only at the death of the settlor. Suddenly, the settlor is still alive, the trustee receives a large amount of money from the life settlement, and the trust agreement is not drafted satisfactorily to handle the situation. This was not expected when the trust was drafted years ago. Does anyone have an idea on how to handle this situation?

Lee Slavutin: Wouldn’t there be a provision in a trust that one can sell assets?

David Hirschey: The trustee can do that, but, generally, while the settlor is alive, the trust agreement may provide for payment of income, but often there is no authorization to pay principal. The dispositive provisions of the trust are not satisfactory. Has anyone else encountered this problem?

Richard Oshins: I think the moral of that is that you have to draft trusts with provisions for discretionary distributions during lifetime, as well as at death.

Wallace Head: If you are trustee of an ILIT that holds term insurance and for whatever reason the funding needed to maintain the coverage stops and the insured is at an advanced age, say 75 years old, do you have an affirmative obligation as trustee of that ILIT to at least attempt to implement a life settlement? And, if you do have such an obligation, but you do not even attempt to implement a life settlement, what is your exposure?

Lee Slavutin: Wally, I am not sure how to answer that from a trust point of view, but just from an economic point of view, it is certainly worth finding out if a term policy on a 75-year-old can be sold, because the trust could get a lot more money than by just canceling the policy. The other point is that with a term insurance policy for a 75-year-old, it will not be a viable policy for sale unless it is convertible to permanent insurance.

Richard Oshins: I think a lot of us lose the perspective when you are the trustee of a life insurance trust that your duty is to the beneficiary, not to the grantor. You have that obligation to make the trust productive because of the beneficiaries. That being said, there are people who get an uncomfortable feeling about having life insurance on their lives owned by a stranger. So, perhaps what you might do is find out what the proposed settlement would be, go to the grantor and say, "Would you like to buy this policy?" By doing that, the insured can put money into the trust outside of his or her estate and you have avoided making the grantor uncomfortable, which is something that you probably want to do, and also take care of your fiduciary obligation as to the beneficiaries.

Wallace Head: Dick, do you see any tax issues if the grantor in your example does purchase a convertible term policy from the trust for the amount of a non-binding offer for a life settlement, say \$250,000, and then the grantor converts the coverage and never makes another premium payment?

Richard Oshins: I do not think there are any issues. I think the policy just blows up. I do not think there is a gift tax problem. You bought it for its then-fair market value and you have determined what the fair market value is. In fact, I think a lot of us overlook the fact that there is a fair market value to these policies when they are being transferred and people are looking at a cash surrender value. They are not looking at the value that you can get in the marketplace. It has basically been a "wink-wink" situation that I have never felt comfortable with. When we do our planning, we like to put all our cards on the table. But, there are people who just pick the value that is most beneficial in that situation, and I do not think you can do that.

Wallace Head: I think this points out one of the other risks of being trustee of an ILIT. Generally, the trustee

of an ILIT is not being paid to do any of this work, yet the trustee may have an obligation to the beneficiaries to do the work that Dick described.

Ben Baldwin, Jr.: With respect to what is going on in the corporate trustee world, as far as managing and being part of the decision-making process to purchase life insurance for the grantor, it appears that the state of the art today is that most trustees are considering it a custodial asset, not a trust asset, and treating it in that fashion.

The issue is, can trustees continue to treat trust owned life insurance (TOLI) as a custodial asset? Is it going to be too difficult or too unprofitable for corporate trustees or individual trustees to find a way to manage life insurance? I would love to hear your thoughts on this.

Lee Slavutin: When you say a custodial asset versus a trust asset, what do you mean?

Ben Baldwin, Jr.: Basically treating it custodially and doing whatever the grantor wants. If it is considered a trust asset, it would be under the Uniform Prudent Investor Act as adopted by the individual states and trustees would be subject to all the requirements of treating it as an investment, addressing diversification, etc., the same as is required for any other trust asset.

Lee Slavutin: What allows a trustee to treat insurance differently? Why are you allowed to do that?

David Hirschey: There isn't any authority for that.

Richard Oshins: I am not sure I agree with that. If you buy a life insurance policy and you are expecting me, as the grantor, to come in and give you money to pay the premiums, I think one of the things that you need to take into account is, that if you do not purchase what I want you to purchase, I am not going to continue making those gifts. And, if I do not make the gifts, you might be buying a different policy, but you are not going to be able to make those premium payments. So, that is putting the trustee between a rock and a hard place. It is not the same thing as an asset that you have absolutely full control over. Here, there is an expectation of continuing payments and, frankly, if I am the grantor and you decide you are going to buy something different, I might just tell you, I am not going to continue giving you money.

Ben Baldwin, Jr.: That is obviously true, and of course, as a result of that, a number of ILITs have been put together with the gift into the trust being income-generating property that is providing sufficient income to provide whatever premium payments need to be made on the life insurance. That puts the grantor outside of the process entirely.

Richard Oshins: Most of the trusts we do are funded life insurance trusts. We do not use *Crummey* gifts as often as some firms. What we do is use income-producing assets. If the facts permit, the preferred strategy is to use a new business or investment opportunity to fund it, so we have a wealth shift with assets and a life insurance trust that is combined, or we use it in an installment note sale.

A caveat that I would like to mention is that some of the carriers are now advocating grantor retained annuity trusts (GRATs), with the remainder interest going into an ILIT. I think you need to be careful if that happens, because, at the end of the GRAT term, if the property goes into an ILIT, depending on how the trust is drafted, there may be an automatic allocation of GST exemption, and the result is a trust that is partially exempt and partially nonexempt, in other words—a mess. This is something that is being marketed quite a bit by some of the life insurance trusts in that category of 43 companies that Lee mentioned earlier.

Financial Strength and Exposure to Derivatives

Ben Baldwin, Jr.: I have another observation on the financial strength of insurance companies. Although there are 43 carriers that are in that top classification by Joe Belth, they were not always in that classification, and they will not always be in that classification. Past downgrades and failures of large insurance companies have happened rapidly and usually as a result of some surprise event, so expecting any insurance company to remain in the top 43 for the duration of an insured's lifetime is risky. Another topic for discussion Lee, is that the National Association of Insurance Commissioners (NAIC) is looking at the valuation of hybrid securities that are being heavily used by the life insurance industry in their general accounts. A lowering of the NAIC classifications for hybrid securities will increase an insurance company's risk base capital requirements and reduce its risk based capital ratio and cause a rating reduction by the various rating services. Could this be the next "surprise" for the insurance industry? Your comments and thoughts on that issue, please?

Lee Slavutin: When you say hybrid securities, you are referring to what?

Ben Baldwin, Jr.: The hybrid securities are types of hedge arrangements incorporating both debt and equity.

Lee Slavutin: I do not know what exposure each of these companies has to that type of investment. Obviously, based on what you are saying, a company that has a large exposure might get downgraded. But, I cannot give you a specific comment.

Ben Baldwin, Jr.: Just yesterday, in size of volume, we are talking about a \$75 billion marketplace in which in-

surers hold \$45 billion, or 60 percent of the total market. That is why the concern is being raised.

Lee Slavutin: Even with \$45 billion, it depends on how many companies this amount is being spread across because, obviously, these companies have lots of other assets.

Ben Baldwin, Jr.: True. It is a concern that was voiced by one of the largest life insurance companies in the nation, and of course a great many of the smaller ones. It has been reported that lingering confusion about the risk classification of hybrid securities could scare investors away from the insurance sector and threaten some companies' financial stability.

Regulatory Climate

Sidney Kess: Ben, what about the regulatory climate?

Ben Baldwin, Jr.: Yes, I would like to title this discussion as "Regulation or Strangulation." There has been a great deal going on in the insurance business and advisory business in which anybody that is NASD licensed cannot use terms like "financial planning" or "financial advisory," without being a registered investment advisory firm.

The NASD now stands between the registered representative and their clients and, in effect, today, dictates what may be said from the representative to the client, even though the client is seeking an advisory relationship with the representative and the representative is likely to have a good deal of education and credentials indicating competence in giving advice. In fact, an agent today has standing between him and the client, a compliance officer, an agency manager, an insurance company, product providers, and, obviously, the NASD. That distance between that agent and the client is creating a great deal of frustration in the industry. It is a problem that is forcing some people to consider dropping NASD licensing and going strictly to Registered Investment Advisor status.

There was a meeting in New York this past January, hosted by PriceWaterhouse, in which the financial service industry participants said that, compliance is their greatest concern and their greatest expense as they look into the future. Lee, do you have any thoughts on that?

Lee Slavutin: Compliance has changed the way we practice. It is just a whole new world.

Wallace Head: Lee, broker-dealers have had their mail opened by compliance officers for years. And, if you are a public company, you have all this compliance and regulatory oversight, plus Sarbanes-Oxley. But, as

a citizen observing the situation, the financial services industry may have gotten what it deserved because of the way many of its members abused clients and customers. When you look at some of the practices that have gone on for years in the investment and insurance businesses, increased compliance is well deserved.

The baby may get thrown out with the bath water, or some such analogy, and everybody gets painted with the same brush. Even those of us who think we were behaving properly and complying all along end up having the same hassle and expense that befalls those who caused the problem. But, there clearly are some valid reasons for a lot of this added compliance burden.

Ben Baldwin, Jr.: There was a speech that I heard recently in which an NASD regulator was explaining to the industry what it should do in preparation for an inspection. From the degree of reporting and paper, you could see that the regulatory agency was insistent on looking at process, evaluating process. "If your process isn't right, we will fine you."

All of those resources are being spent checking on the paperwork of so many ethical representatives. That takes away resources that could be used to go after the people that should go to court and should be put in jail. It is likely that the cost and oppressive nature of the current ineffective regulatory environment will force some changes in the near future. ♦

Examining the Role of Insurance Trustees

Ben Baldwin Jr., Wallace Head, David Hirschey, Stephen Krass, Richard Oshins, and Steven Weinstein discuss the role of the corporate trustee in life insurance purchase and management.

Ben Baldwin, Jr.: Steve, what role do corporate trustees play in managing, purchasing, being involved with life insurance decisions of a grantor?

Stephen Krass: I find mostly in my clientele there are very few corporate trustees. My clients tend to be entrepreneurs, and entrepreneurs tend to have individuals as trustees as opposed to corporate people who tend to go with corporate trustees. So, I have not seen too much in that area.

Ben Baldwin, Jr.: How about your individual trustees? Are they involved in the management of life insurance decisions?

Stephen Krass: The trustees are generally family members. It can very well be a trust created by the husband with the wife as the trustee, so there is not an inde-

pendent thought as to what insurance or what style of insurance is going to be done at that particular time.

Ben Baldwin, Jr.: So, the grantor makes the decision?

Stephen Krass: Yes.

Ben Baldwin, Jr.: Dick, how about you?

Richard Oshins: My experience has been that the grantor with the life insurance professional will sit down and make the decision. But, our firm often works in the life insurance world, so we will guide them at times, depending on what is being proposed.

Ben Baldwin, Jr.: So, you will act as an advisor and reviewer for whatever the life insurance proposal happens to be?

Richard Oshins: Yes, generally if it is an accomplished professional in the life insurance business and we are comfortable with them, we will let them, basically, decide what they want to do. But, at times you get proposals that are obviously wrong.

Stephen Krass: Remember, we are representing that client in this situation.

Ben Baldwin, Jr.: Exactly, and obviously a benefit to the client. At least we are going to look at it with one more professional set of eyes. Steve Weinstein, do you have a corporate trustee getting involved with life insurance decisions?

Steven Weinstein: Rarely.

Ben Baldwin, Jr.: So, the grantor is making the decisions on the life insurance and then the trustee takes over what the grantor has decided on and purchased and picks up whatever liability or responsibility that carries with it.

Steven Weinstein: Generally yes, if you are just talking about a traditional irrevocable life insurance trust (ILIT). Typically, the children or spouses are the trustees and, to be honest, there is not a lot of work to do until after the death of the insured. Are you referring to pre-death or post-death or both?

Ben Baldwin, Jr.: Pre-death, while the insured is living.

Steven Weinstein: I just have not found there to be that many issues. It is funny that you mention this issue because yesterday I was at a meeting with a client—the insured—and the insurance agent and we were talking about policies owned by the irrevocable life insurance