

Life Insurance Planning in the Last Quarter of 2020

**By: Lee Slavutin, Richard L. Harris, Steven
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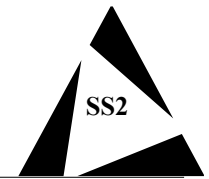
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Life Insurance Planning in the Last Quarter of 2020

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Opportunities in the Last Quarter of 2020

Three factors will influence planning in the last quarter of 2020:

1. Federal election – possible change to Democrat-controlled White House and Senate – lower gift tax exemption
2. Low interest rates
3. COVID 19 Pandemic

1. Impact of Federal Election on Gift Tax Exemption

- An individual can exclude \$11.58 million in 2020; a married couple can exclude \$23.16 million.
- If Joe Biden becomes President and the Democrats gain control of the Senate, it is likely that the gift and estate tax exemptions will be reduced and that change could become effective on 1/1/2021
- What strategies can be implemented to preserve the exemption?
 - How can we plan for a possible change in tax law in 2021?

1. Make Large Gifts before 12/31/20

Making large gifts may require new trusts and appraisals of assets to be transferred. Gift planning will have to start months not weeks before 12/31/20. Consider two strategies:

1A. Pre-fund insurance trusts to anticipate tax law change

Planning for a possible reduction in the gift tax exemption.

1B. Check funding of existing policies, especially for interest-sensitive universal and whole-life policies

Make gifts to the trust if policies are underfunded

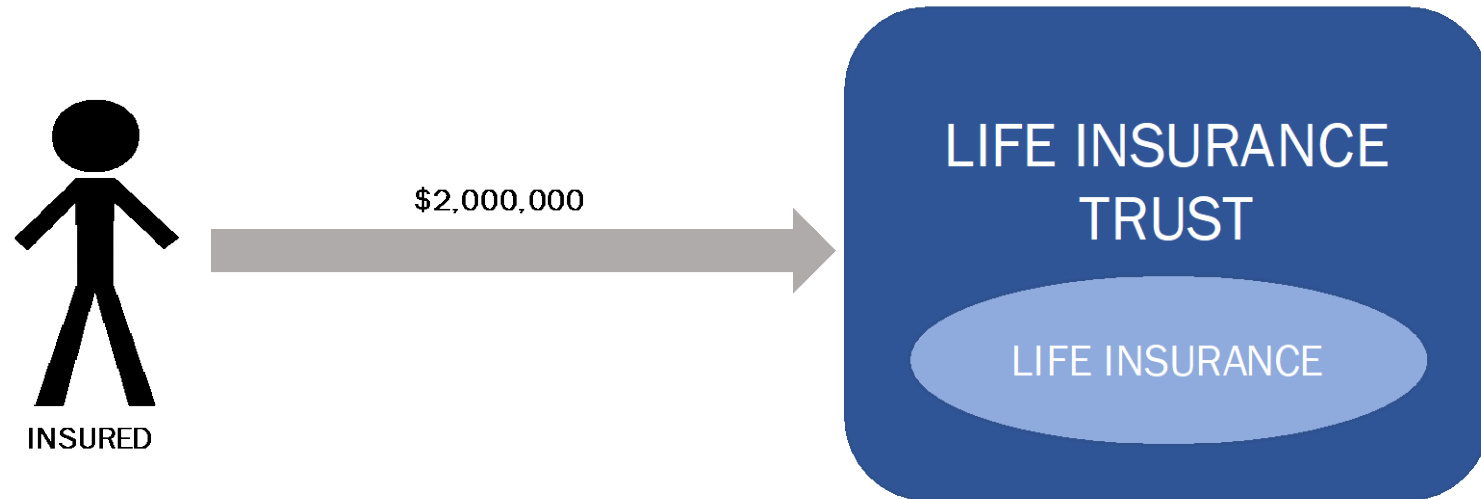
1A Pre-fund Insurance Trusts to Anticipate Tax Law Change

- The gift and estate tax exemption may be decreased in 2021 if Democrats gain control of the White House and the Senate.
 - In 2016, Democrats favored a lifetime exemption of \$3.5 million
 - There could also be a reduction in the annual gift exclusion, for example, by limiting the amount a donor can give away in any given year

1A Gifts – Pre-fund Life Insurance Trusts

- Clients can use the current \$11.58 million exemption to fund the purchase of a life insurance.
 - Example: Client could purchase a \$5 million life insurance policy with annual premiums of \$100,000 payable for 30 years.
 - To lock in the current gift exemption, client can make a lump sum gift to the trust now
 - With discount for investment earnings, a gift of \$2.0 million, for example, to an irrevocable life insurance trust could be used to prepay all premium payments.

1A Gifts – Pre-fund Life Insurance Trust



1A Pre-fund Trust – Avoid Modified Endowment Contracts (MEC's)

- When funding insurance policy premiums upfront, planners should be aware of the modified endowment contract (MEC) rules.
 - If a life insurance policy is funded with a large single premium, it will become a MEC and lifetime distributions from the policy will be taxable if the policy has any built-in gain
 - To avoid MEC status, a large gift can be made to the trust (not the policy) and each year the trust can pay the premiums from its invested assets
 - In this example, the trust would invest the \$2 million gift and pay \$100,000 each year to the insurance company

1B Trust-owned Life Insurance – Is Existing Policy Adequately Funded?

- Low interest rates have resulted in decreased interest crediting rates for universal life policies and lower dividends for whole life policies.
- We can expect further decreases in interest crediting rates and dividends in the next two years.
- It is important to obtain updated in force illustrations of these policies to see if they are adequately funded.

1B Trust-owned Life Insurance – Adequately Funded?

➤ Example:

- Male, 67, has a \$5 million face amount universal life policy
- He purchased the policy 20 years ago
- His current annual premium is \$50,000
- An updated in force illustration shows that the policy will lapse at age 79, based on current interest and mortality rates

1B Trust-owned Life Insurance – Adequately Funded?

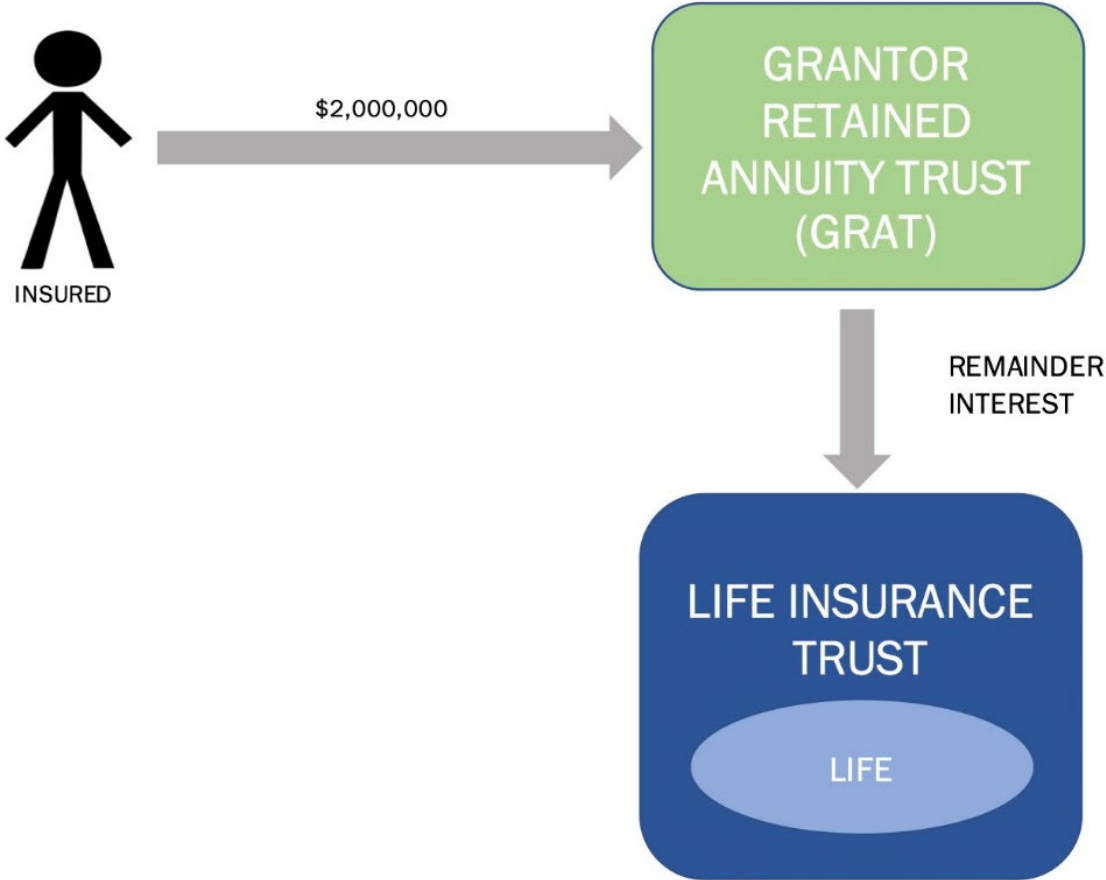
➤ Possible solutions:

- Increase the premium payments by making additional gifts to the trust now
- Lower the death benefit if the client's budget is limited
- Consider replacing the policy with a new policy if better pricing is available
 - A careful comparison of the existing policy and the new proposed policy must be made to understand potential disadvantages of replacement

1B Trust-owned Life Insurance – Adequately Funded?

- Possible mechanisms for making additional gifts to the trust:
 - Lump sum gift this year
 - Create a GRAT (Grantor Retained Annuity Trust) that names the insurance trust as a remainder beneficiary. GRAT's typically have a short duration of 2 to 10 years. When the GRAT terminates, a life insurance trust can be the remainder beneficiary and receive the GRAT assets. The GRAT would be created in 2020 to take advantage of the current large gift exemption.

1B Trust-owned Life Insurance + GRAT



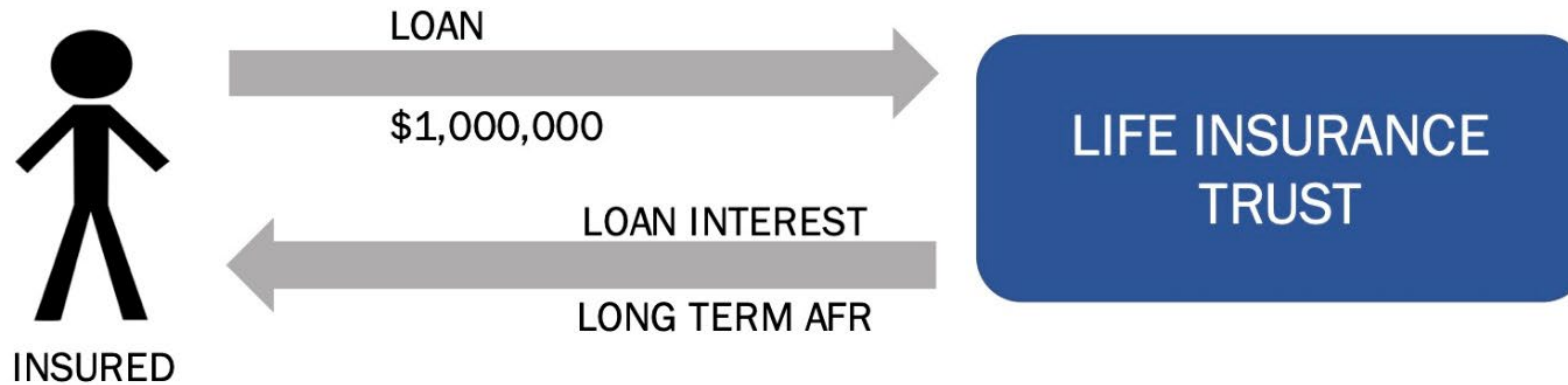
2. TAKE ADVANTAGE OF LOW INTEREST RATES

- The 7520 rate is at a record low of 0.4%
- Certain strategies work well in a low interest rate environment:
 - 2A. Split dollar loan
 - 2B. Premium financing

2A PRIVATE SPLIT DOLLAR LOAN

- Insured lends money to the insurance trust.
- The loan is set up as a long term note at the applicable federal rate.
- The trust pays interest each year to the insured.
- The trust uses the loan to purchase life insurance.
- Assuming the trust can earn more than the loan interest rate, the excess earnings can be invested and used to repay the loan in the future.

2A SPLIT DOLLAR LOAN



2B Premium Financing

- Bank lends money to the trust each year
- Insured makes gifts to the trust to pay the interest on the loan
- The trust buys life insurance
 - A whole life policy that accumulates substantial cash value can provide some or all of the funds to repay the loan in the future

2B Premium Financing

- Client should consider a large gift to the trust this year for two reasons:
 - Take advantage of the \$11.58 million gift tax exemption
 - Use the gifted assets to fund all future interest payments on the loan and to repay part or all of the loan principal

3. Impact of COVID 19 Pandemic

- The COVID 19 Pandemic affects insurance companies as follows:
 - Increased mortality claims for life insurers
 - Increased business interruption and event cancellation claims for property/casualty insurers
 - Low interest rates lowers investment earnings

3. Impact of COVID 19 Pandemic

- Financial strength is the most important factor that the client should consider in choosing a life insurance company
- The COMDEX Score is a helpful screening tool – the highest possible score is 100 - we generally prefer companies with a score over 90

Life Insurance Planning in the Last Quarter of 2020



Presented by:
Richard L. Harris, CLU AEP

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Topics to be Covered

- Loan split-dollar – paying life insurance premiums without making taxable gifts
- Effect of low interest rates on current policies and what to do about it
- Effect of low interest rates on new products
- Effect of low interest rates on carriers

What a Loan Split-Dollar Arrangement Can Do That Other Section 7872 Loans Cannot

- Pay life insurance premiums without making taxable gifts
- Loan for the life of the insured
- Interest accrued (if grantor trust no income tax consequences)
- Lump-sum loan locks in current AFR forever
- Loan treatment guaranteed
- Covered by Regulations

New Split-Dollar Rules

2001-2003: The Split-Dollar World Changes

New regulations in Sept. 2003

90 Pages including preamble

- §1.61-22
- §1.7872-15

Creates New Opportunities

What the Regulations Say

Economic benefit split-dollar §1.61-22

§1.61-22(a)(b) and (c) provide the definition of split-dollar for both economic benefit and loan arrangements

- §1.61-22(b)(2) excerpted and paraphrased
In General – arrangement between owner and non-owner of a policy where either party “...**pays directly or Indirectly, ALL** or any portion of the premiums on the life insurance contract...”(emphasis added)

What the Regulations Say

Loan Split-Dollar – New Game in Town

Important provisions
§1.7872-15(a)(2)(i)(C)

The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

What the Regulations Say Loan Split-Dollar

Important Provisions §1.7872-15(d)(i) & (ii)

Loan treatment can be guaranteed – even if nonrecourse

“Requirement. An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment under this section if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.”

What the Regulations Say Loan Split-Dollar

Important Provisions

§1.7872-15(e)(5)(ii)

Loan can be repayable at death of the insured

- Applicable Federal Rate (AFR) determined by life expectancy using table in §1.72-9
 - If life expectancy is more than nine years, long-term AFR is used
 - September 2020 long term AFR **1.00%**

What the Regulations Say Loan Split-Dollar

Important Provisions

§1.7872-15(g)(4)

(See also Examples in §1.7872-15(h)(5))

Interest can be accrued

Grantor Trust rules §§671-679 and §1.671-2

- No OID if Grantor Trust
- (Successor Grantor?)

Reprise: What a Loan Split-Dollar Arrangement Can Do

- No taxable gifts
- No estate or generation-skipping taxes
- Loan for the life of the insured
- Interest accrued (if grantor trust no income tax consequences)
- Lump-sum loan locks in current AFR forever
- Loan treatment guaranteed
- Covered by Regulations

And the leverage of life insurance

Current Interest Rate Environment Effect on Life Insurance Products

Currently in force:

- Whole Life and General Account UL
 - Dividends will decrease going forward
 - Interest rate on UL will decrease, possibly to guaranteed minimum
- Equity Indexed Universal Life
 - Cap rates (maximum rate credited on index) will decrease
 - Spreads (amount deducted before index rates are credited) will increase
 - Increased market volatility also a negative
- Older clients will be more adversely affected because of shorter life expectancy

Current Interest Rate Environment What to Do for Clients

IMPORTANT

- Get in force illustrations for all existing policies
- Ask for lower index, crediting rate or interest assumptions than currently projected
- Make clients aware of the issues

Current Interest Rate Environment What to Do for Clients

Options:

- Revisit purpose for insurance
- Increase funding
- Decrease death benefit
- Take reduced paid up policy
- Borrow from commercial lender
- Ask beneficiaries to pay
- Surrender or sell in life settlement market

Current Interest Rate Environment Effect on Life Insurance Products

New Products:

- Universal Life policies are being repriced
 - Increased cost of insurance and/or expenses will give carriers a cushion
 - Will be more expensive than old products
 - Guaranteed Universal Life especially affected
- Term insurance, because of reserving, may become more expensive

Current Interest Rate Environment Affect on Life Insurance Companies

- Downward pressure on profits
- Upward pressure on reserve requirements
- Can create solvency issues for carriers with riskier products and/or riskier investments
- Check insurance credit reporting agencies –
COMDEX

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“Misleading” Life Insurance Illustration Class Action Lawsuit Filed August 2020

Presented by: Steven S. Zeiger, CEBS, TEP

September 2020



How To Protect Your Clients From “Excessive Costs”, “Undisclosed Risk”, “Indefensible assumptions that are unsupportable, unsustainable and actuarially unreasonable”

- Discuss the allegations presented
- Examine a sample proposed illustration:
 - Illustrations comingle costs and performance
 - Impossible to correctly determine Costs, Performance or Risk
- Examine the “policy charges” AKA detailed expense pages
 - “Examine, Investigate, Justify” Costs, Performance and Risk
 - Based on guidance from FINRA, the OCC, the UPIA, NYS DFS Reg 187, CFP Practice Standard, etc.

The Lawsuit Alleges the Following

1. “Violation of Unfair Competition Law Business & Professions Code § 17200, *et. seq.*”
2. Fraud and Deceit
3. Intentional Misrepresentation
4. Negligent Misrepresentation
5. Breach of Fiduciary Duty
6. Professional Negligence”

Direct Quotes From the Lawsuit Common in the Industry

- *“leveraged IUL product”* ... *“is impossible to understand, impossible to explain to clients and impossible [for agents] not to sell, simply because it illustrates the best.”*
- *“illustrations intentionally overstates the future performance of these IUL policies, while failing to disclose critical policy attributes and components that operate collectively to dramatically increase the costs and risks associated with these highly leveraged insurance products.”*
- *“Policies would not and could not perform as represented given:
(a) the excessive embedded undisclosed base charges,
(b) the undisclosed risks to the illustrated performance, and
(c) deceptive utilization of a mysterious multiplier”*

Direct Quotes From the Lawsuit

- “fraudulently inflated the illustrated performance developed to circumvent and evade Actuarial Guideline 49 (“AG 49”) promulgated by the National Association of Insurance Commissioners (“NAIC”), which was specifically adopted to curtail misleading excessive illustrated interest rates in IUL illustrations”
- “misleading illustrations showing outsized yet unattainable returns far higher than the limit imposed by AG 49.”

Direct Quotes From the Lawsuit

- “assumes the call options will generate profits of 50% *in perpetuity*, on each transaction, an indefensible assumption that is unsupported, unsustainable and actuarially unreasonable. The high policy charges and inflated assumed option trading profits operate in tandem to create a tremendous degree of leverage”
- “Policy performance, resulting in enormous undisclosed risks – including substantial market risks.”

The Hypothetical Illustrated Returns- illustration Page 11

The Allocations and Hypothetical Interest Rates below are for policy year 1.

	Allocation	Hypothetical Interest Rate
Fixed Account	10.00%	2.50%
1-Year Indexed Account	10.00%	5.67%
1-Year International Indexed Account	10.00%	5.64%
1-Year High Par Indexed Account	10.00%	4.92%
1-Year No Cap Indexed Account	30.00%	5.67%
1-Year High Cap Indexed Account	30.00%	7.05%

Therefore the actual illustrated rate is 5.89%

$$\mathbf{\$100 \times .025 = \$2.50}$$

$$\mathbf{\$100 \times .0567 = \$5.67}$$

$$\mathbf{\$100 \times .0564 = \$5.64}$$

$$\mathbf{\$100 \times .0492 = \$4.92}$$

$$\mathbf{\$300 \times .0567 = \$17.01}$$

$$\mathbf{\$300 \times .0705 = \$21.15}$$

Total hypothetical return \$56.89 or 5.89%

The Hypothetical Illustration

Comingled Costs and Performance ages 75 to age 84

Non-Guaranteed Policy Values: Ledger

Non-Guaranteed Values (End Of Year) @ Varying Rate ¹							
Year	Age	Premium Outlay* (1)	Accumulated Value (2)	Cash Surrender Value (3)	Death Benefit (4)	Cash Surrender Value Internal Rate of Return (5)	Death Benefit Internal Rate of Return (6)
31	75	0	1,904,424	1,904,424	1,999,645	6.13%	6.35%
32	76	0	2,045,558	2,045,558	2,147,836	6.18%	6.39%
33	77	0	2,196,442	2,196,442	2,306,264	6.23%	6.43%
34	78	0	2,357,672	2,357,672	2,475,556	6.27%	6.47%
35	79	0	2,529,890	2,529,890	2,656,384	6.31%	6.50%
36	80	0	2,714,143	2,714,143	2,849,851	6.34%	6.52%
37	81	0	2,906,705	2,906,705	3,052,040	6.37%	6.54%
38	82	0	3,107,914	3,107,914	3,263,310	6.39%	6.56%
39	83	0	3,318,180	3,318,180	3,484,089	6.40%	6.56%
40	84	0	3,537,468	3,537,468	3,714,342	6.40%	6.56%
Total		500,000					

The illustrated IRR is 6.13% in year 31

Policy Charges age 75 to age 84

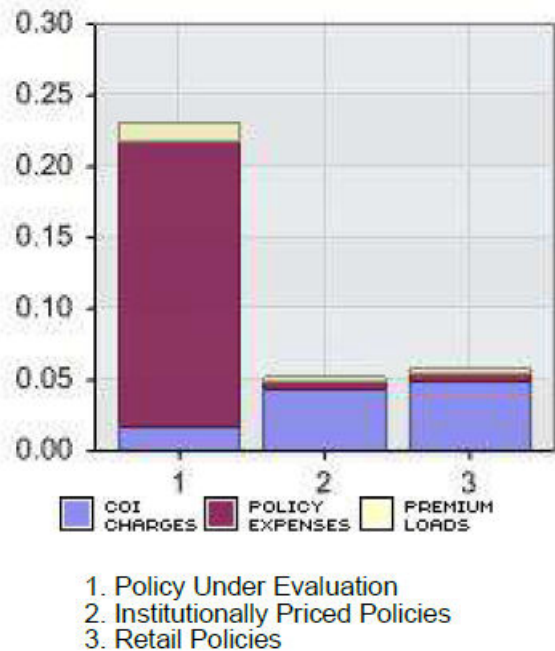
Separating Cost From Performance Exposes Undisclosed Risk

Year	Age	What You Pay Premium Outlay*	What We Deduct					Total Charges	What Is Added	What Your Policy Values Are ¹				Policy Charges As A Percentage of Gross Accumulated Value ³
			Non-Guaranteed Premium Loads ²	Administrative and Rider Charges	Non-Guaranteed Coverage Charge	Non-Guaranteed Cost of Insurance	Interest Credit ¹		Accumulated Value	Policy Surrender Charge	Cash Surrender Value	Alternate Accumulated Value		
31	75	0	0	-58,398	0	-1,239	-59,636	191,592	1,904,424	0	1,904,424	513,298	-3.13%	
32	76	0	0	-62,793	0	-1,465	-64,258	205,393	2,045,558	0	2,045,558	521,962	-3.14%	
33	77	0	0	-67,498	0	-1,733	-69,231	220,115	2,196,442	0	2,196,442	530,528	-3.15%	
34	78	0	0	-72,533	0	-2,049	-74,583	235,813	2,357,672	0	2,357,672	538,946	-3.16%	
35	79	0	0	-77,919	0	-2,408	-80,326	252,544	2,529,890	0	2,529,890	547,170	-3.18%	
36	80	0	0	-83,676	0	-2,840	-86,516	270,769	2,714,143	0	2,714,143	555,121	-3.19%	
37	81	0	0	-89,831	0	-3,938	-93,769	286,331	2,906,705	0	2,906,705	562,122	-3.23%	
38	82	0	0	-96,271	0	-5,171	-101,442	302,651	3,107,914	0	3,107,914	568,016	-3.26%	
39	83	0	0	-103,006	0	-6,549	-109,555	319,821	3,318,180	0	3,318,180	572,635	-3.30%	
40	84	0	0	-110,052	0	-8,080	-118,132	337,420	3,537,468	0	3,537,468	575,798	-3.34%	
Total		500,000	-29,500	-1,749,110	-74,203	-77,040	-1,929,853	4,967,321						

In year 31, the interest credited on the \$1,904,424 cash value is \$191,024
An annual return of 10.03%
IUL is classified as a conservative/moderate general account product.

Comparing Costs to Industry Benchmarks

Policy Expense Breakdown



Policy Expense Breakdown measures the present value cost per \$ of Death Benefit and the individual cost components, assuming identical funding amounts and funding patterns for a policy issued to a 45 year old male Non-Smoker Preferred + risk.

Research provided by:



What Does Morningstar have to say about costs?

“The expense ratio is the most proven predictor of future fund returns.”

“If there's anything in the whole world that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds.”

Do you think these costs matter for life insurance?

Conclusion: High internal costs, misleading performance, under-disclosed risk

19.07% Amount Credited Is Not 4.95%

A LIFE INSURANCE POLICY ILLUSTRATION

A Flexible Premium Universal Life Insurance Policy

Annual Account Summary

Illustration Assumptions

James Farber
 Male - Super Preferred NonSmoker
 Age: 60

Initial Death Benefit \$8,000,000
 Face Amount \$8,000,000
 Initial Planned Premium: \$181,047.00 / Billing Mode: Annual
 Death Benefit Option 1; Cash Value Accumulation Test
 State: South Dakota

Based on Current Charges and an Initial Current Rate of 4.95%

Policy Year	Planned Premium	Premium Charge	Admin/ Contract Charges	Insurance Charges	Amount Credited	Policy Value	Surrender Charge	Net Surrender Value
21	0	0	49,786	150,978	260,171	1,604,587	0	1,604,587
22	0	0	49,786	170,244	278,653	1,663,210	0	1,663,210
23	0	0	49,786	191,970	299,300	1,720,755	0	1,720,755
24	0	0	49,786	216,563	322,008	1,776,414	0	1,776,414
25	0	0	49,786	246,751	348,731	1,828,608	0	1,828,608
26	0	0	49,786	281,308	378,993	1,876,508	0	1,876,508
27	0	0	49,786	317,371	411,990	1,921,342	0	1,921,342
28	0	0	49,786	361,362	452,660	1,962,855	0	1,962,855
29	0	0	49,786	424,709	511,313	1,999,674	0	1,999,674
30	0	0	49,786	498,992	580,020	2,030,916	0	2,030,916

Ethical Alternatives to Illustration Comparisons

- NO illustration comparisons in trust/client file.
- Insist on Detailed Expense Pages- see page 9 and 11
 - Insurer, Excel, Independent Research
- At a MINIMUM, compare costs & performance SEPARATELY
- Benchmarking is well-established & common in the financial services industry.

Ethical Alternatives to Illustration Comparisons

- Illustration comparisons inconsistent with duty to exercise care, skill, prudence, and diligence.
- Benchmarking costs SEPARATE from performance is ...
 - Well-established, common & proven
 - Consistent with NY DFS Reg 187 and CFP Fiduciary Standard
 - FINRA Reviewed

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