Using the New Lifetime Exemption Amounts to Bolster (or Save) Existing Life Insurance

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Given the relative complexity of the product, reviewing in-force (existing) life insurance policy performance has always proven valuable, as it not only allows for a re-education of the policy mechanics, it also updates the policy owner on where the policy stands in relation to the initial projections (illustrations). With actual return and cost assumption changes having potentially deviated from the original “as sold” or “illustrated” projections, regularly reviewing life insurance policies is important, for both financial and estate planning purposes. This reality, coupled with the recent tax reform changes increasing lifetime gifting limits, makes this an ideal time to audit policies, to provide clarity on where they stand, and examine both policy and market options and alternatives to bolster, innovate, restructure, or save, existing life insurance. This would also include exploring the exiting of split dollar or premium finance arrangements. Further aiding the appropriateness of current policy reviews are new lower marketplace mortality costs, potentially improving policy performance through lower cost of insurance; policy maturity dynamics (i.e., policies expiring at age 95 or 100); and historically low interest rates, which allows for efficient premium borrowing.

NEW TAX LAW, NEW GIFTING LIMITS: TIMELY OPPORTUNITY OR NEW NORMAL?

With the signing into law, on December 22, 2017, of the 2017 tax act,1 Congress significantly amended the Code2 (the last time the United States saw significant tax reform), to include a roughly doubling of the estate and gift tax lifetime exemption amount for individual taxpayers, from what in 2018 would have been $5.6 million (up from the 2017 amount of $5.49 million) to an estimated $11.2 million per person. For married couples, this means the combined total is now roughly $22.4 million.3 Think of the $22.4 million as a “deductible” for the estate tax. Assuming the first spouse to die has elected “portability” on their estate tax return (important and necessary to achieve the combined exemption amount), the couple is taxed the 40% tax (current rate under the 2017 tax act) on only asset values above the $22.4 million exemption amount.4

Although due to sunset at the end of 2025, these higher lifetime exemption amounts offer, from a historical perspective, a notable increase over the history of lifetime exemption amounts. The roots of the recent increases in lifetime exemption amounts stem from The Economic Growth and Tax Relief Recon-

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2 All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.
3 The 2017 tax act, §11061, increases the basic exclusion amount provided in §2010(c)(3) from $5 million to $10 million (indexed for inflation occurring after 2011) for “estates of decedents dying, generation-skipping transfers, and gifts made” after 2017 and before 2026. The indexed amount for 2018 is calculated using “Chained CPI.” Dan Evans (lawyer in Philadelphia, Pennsylvania) has estimated that the basic exclusion amount for 2018 will be $11.18 million. Daniel Evans, Summary of the Reconciliation Act of 2017 (Dec. 25, 2017); http://resources.evanslegal.com.
ciliation Act of 2001,\textsuperscript{5} which escalated the lifetime exemption amount each year from its inception, with an initial amount of $675,000, and capping out at $3.5 million in 2009, before the estate tax was repealed for one year, in 2010.\textsuperscript{6}

Tax years 2011 and 2012 were based on the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, signed into law on December 17, 2010 by President Obama.\textsuperscript{7} The law was to expire, or “sunset,” on December 31, 2012, when the federal estate tax exemption rate would have reverted on January 1, 2013, to 2001 levels, i.e., $675,000. However, instead of that happening, Congress passed the American Taxpayer Relief Act (ATRA) on January 1, 2013, and President Obama signed it into law on January 2, 2013. ATRA made permanent changes to the laws governing federal gift and estate taxes, as well as the generation-skipping transfer (GST) taxes. The potential of the lifetime exemption returning to $675,000 per person (from roughly $5 million) drove a great deal of gift planning, some more hurried than others, in 2012. This planning assumed gifts made before 2013 would be grandfathered.

So, here we are in 2018 with a $22.4 million lifetime gift exemption. Will it sunset at the end of 2025, or be changed if control of Congress changes hands? No one knows, of course — given it was below $1 million for decades, and the general modern legislative uncertainty that exists — but exploring making the gifts during one’s lifetime (read: now) is prudent. Planners are already helping clients explore which of their assets are best to gift (to trust, children outright, or other). Ideal asset types include those that allow for significant growth, to provide leverage. Examples include: private company stock, real estate, partnership interests, and life insurance. Life insurance is often an overlooked asset class that has significant leverage, tax, and liquidity benefits. Although new life insurance should be among the considerations clients are exploring when considering lifetime gifts, this article will focus on targeting existing life insurance policies and portfolios, with an eye on helping save or grow the policy’s ultimate return.\textsuperscript{8}

\textsuperscript{5} Pub. L. No. 107-16.

TESTING, TESTING — READ ALL ABOUT IT: DEFINITION OF LIFE INSURANCE

To understand how a policy can be saved or bolstered, it is helpful to understand both the tax benefits life insurance enjoys, as well as how products qualify as life insurance. Life insurance has favorable income tax benefits, including tax-free death benefits and tax-deferred growth of cash value accumulation. For policies to qualify, they must meet the Code definition of life insurance, which was provided for policies issued after December 31, 1984. At the time of policy issue a policy will use one of two actuarial tests to meet the definition: the cash value accumulation test (CVAT) or the guideline premium and corridor test (GPT). These tests ensure that policies are not funded (over-funded) beyond what the government deems a reasonable level, and were created out of perceived abuses. A policy must pass its relevant test throughout its life, or the policy can lose income-tax favorable treatment. Each of the two tests have distinct calculations and nuances, but in both cases life insurers ordinarily automatically increase the face amount (death benefit) of the policy to ensure they remain in compliance with the definition of life insurance.\textsuperscript{9} This latter reality is where insurance practitioners need to explore with policy owners the potential of bolstering policies with additional premium, using new lifetime exclusion gifts.

EXISTING LIFE INSURANCE AUDIT — WHAT WILL YOU FIND?

Determining what can be done with the new lifetime exemption gifts starts with a deep dive audit of the existing life insurance. The ideal planning scenario for life insurance is that the selling insurance broker, or agent, monitors the life insurance regularly, e.g., annually, with written communication that includes the policy performance along with any important and relevant updates (e.g., potential underwriting improvements, insurance carrier financial changes, etc.) to both the client, and their other professional advisors. This ideal, however, more often than not, can fail to occur and years can go by without a real review of performance.

An audit, or review, examines how a policy has performed to date, and the projected performance (illustration) going forward. Its purpose is to determine whether changes in a life insurance policy, or the policy carrier, have impacted the policy. Such an evaluation could include: examining the policy pric-

Troubled Life Insurance — An Overview

There are a number of ways in which life insurance, whether trust-owned (TOLI) or not, can fail to live up to expectations, and most start with the expectations created at the initial point of acquisition. There are three primary components to “permanent” (not term) life insurance performance: the premium, how much, and for how long; the return of the cash value in the policy, i.e., the dividend, the crediting rate, or variable (market) return; and cost of the risk, i.e., the death benefit or mortality expense. When a policy is purchased, an assumption of each of these components is made, with the most important being the cost of the insurance and the return assumptions. Policies get behind, or in trouble, when assumptions are not met, and too few policies are designed to effectively weather less than “illustrated” performance, because an attempt to keep premiums low was a priority.

In simple terms, if a policy’s return assumption was projected at an annual rate of 6% for the policy to last to the insured’s age 100, but the actual return is 4%, it is possible the policy will not last beyond life expectancy, i.e., age 100, without additional premiums to do so. These potential changes should be explained thoroughly at the time of purchase, and frequent stress/sensitivity tests ought to be run and explained. Unfortunately, quite often the consumer simply focuses on the number of premiums planned for, i.e., the “finish line.” As in any investment, a change of 100 basis points (1%) can have a notable impact on the outcome, or return. For life insurance, it can mean a policy holder who thought 10 premiums would suffice for making the policy work, can have that number double, or even triple.

Other examples of policy problems, in addition to longer than expected premium payments, can include “returning” premiums, where, at one point, the policy projections did not call for additional premiums, but lower dividend (whole life), crediting rate (universal life), or investment return (variable life) forces the return of premiums to sustain the policy to the target age, e.g., age 100 or 105. Policies can also have lowering face amounts (death benefits) because of different outcomes in return assumptions. Lower than expected dividends or crediting rates (than at the time of acquisition) account for much of these problems, but increases in mortality costs can also drive problems. The life insurance carrier does have the right to increase cost and recently carriers have increased cost of insurance charges, largely with contracts with minimum guaranteed crediting rates, such as 4%. Another real problem can be maturity, e.g., the policy contract ends at age 95 or age 100. As we live longer, policy holders worry they will outlive their policies, especially those advanced in age, remaining active and healthy.

The Maturity Dilemma

As noted in at least one national newspaper in the summer of 2017, the life insurance industry and its consumers are grappling with a reality hardly discussed at the time of the insurance sale — the maturity (at age 95, or 100) of the policy, when the coverage ends and the policy terminates. As people have lived longer and mortality has extended, life insurance companies now issue policies that mature at age 120 or age 121. However, there are thousands of older policies on the books that mature at age 95 and 100.10

What happens when a policy matures? The contract ends (it ceases to be life insurance) and a check for the cash value of the policy is sent to the owner of the policy, not the death benefit. If the cash value exceeds the premiums paid, an income tax to the owner is generated. For example, if a trust-owned (TOLI) $1 million policy maturing at age 100 has a cash value of $500,000 when the insured reaches age 100 after having paid $300,000 of premium — the trust receives a check for $500,000, with an income tax bill for the gain in the policy of $200,000. In other words, the tax-free death benefit ($1 million) is lost, and the owner must pay ordinary income tax (not capital gains) on the gain ($200,000). This rule is called the

cost recovery rule. If a policy matures, and the policy is owned by an irrevocable trust, it is the trust that is responsible for the income tax due. If the policy is owned by an irrevocable trust, and the insured has no incidents of ownership in the policy, the proceeds should not be included in the estate. If the trust is a grantor trust for income tax purposes, the trust grantor is the one paying the tax.

There is not a universal fix for this maturity issue, and more attention will likely be given to the subject as additional policy owners run into this problem. Each life insurance company is addressing this individually. One carrier, for example, has offered internal exchanges (to a new policy that matures at age 120) to attempt to address the issue. However, that offer must be accepted, which means the owner must focus on the options and make a decision. The new policy, although it does not require new medical underwriting, needs to be tested and monitored, as the initial policy was only built to last until, for example, age 95. It is possible the new policy will require new premium to get beyond age 100. Others have offered policies to extend beyond 100 as long as at least $1 of cash value remains in the policy at age 100, with an added extension of maturity rider to the policy.

The important takeaway is that checking on your policy maturity factors is a must, so that risk can be assessed. Some policies mature at age 95, others at age 100. Many of the policies with maturity dates at age 94 and 95 were policies issued as late as the mid-1990s — a testament to how far human mortality has grown in the last two to three decades.

One alternative for policy owners may be to explore a §1035 tax-free exchange, to extend the life of the policy. This option is discussed in more detail below, but the maturity issue has grown as a consideration factor when analyzing a policy exchange.

**HEALTHY POLICIES — CURRENT FUTURE LOOKING BRIGHT**

In brief, a “healthy” or on-track policy is, essentially, the opposite of the above. The projections, even with decreased returns, demonstrate the policy will last beyond life expectancy with the premium that was planned. Any life insurance projection, however, is subject to change in the future, especially in today’s marketplace. Therefore, despite the positive outlook, continued monitoring is important.

**Healthy Policies Made Healthier: Adding More Gas to the Tank for Fuel Efficiency**

Prior to the major changes in the lifetime exemptions, when policy owners were often limited to using annual exclusion gifts (e.g., $10,000 a year, or $15,000 currently), a policy on track often ended without discussion of additional premium funding. However, today, with current lifetime exemptions, there is an expanded opportunity (during audit) to explore if additional premium can drive additional policy return, i.e., grow the death benefit.

As discussed above, life insurance carriers must ensure policies continually pass one of two definitions of life insurance tests, the CVAT or GPT. Funding existing policies to maximize funding limits, while still passing the test, can increase policy return, and should be explored with existing policies during an audit, especially in light of the new lifetime exemptions. The life insurance professional can help the policy owner explore such potential outcomes through demonstrating illustrations with various additional premium, and how those premiums will affect the policy’s long-term performance. A decision to do so is, ultimately, both an economic and planning-driven exercise, but one often over looked.

**Today’s Lower Mortality Costs**

A part of any thorough life insurance audit is exploring whether any new insurance products in the marketplace would be superior. One reason they might be is that the pure cost of death benefit today is lower than it was 10, 20, or 30 years ago. This is simply because humans are living longer, and costs have come down as a result. This, however, does not mean life insurance carriers have passed this savings on to the consumer. In other words, if you acquired a policy 20 years ago, the pure cost component — the cost of insurance (COI) component — in the policy, in all likelihood, would be less in a policy issued today, using the updated 2001 Mortality Tables, which all carriers were required to move to in 2001. That’s the easy part to understand. What is not is whether a trust, or insured, can capitalize on it. Like a mortgage refinance, there are components and costs to acquiring a new life insurance, and the benefits have to outweigh the costs. In other words, the long-term lower costs of mortality have to create more value than the costs (underwriting costs, commissions, etc.) of acquiring a new policy.11

It is certainly advantageous to acquire life insurance at an earlier age, but a great deal of the reason is the power of compounding that goes on with the policy cash value, just like Albert Einstein described (“Compound interest is the eighth wonder of the world. He who understands it, earns it . . . he who doesn’t . . . pays it’’). If mortality rates had remained

constant from the 1980 CSO table on, then the exploration for lower cost alternatives would yield a rare find, but given that the pure cost components can be less than a policy bought a number of years ago, there are significant opportunities to innovate life insurance policies, assuming no major deterioration of health. The bottom line is that, even at older ages, e.g., 80–85, there is potential to improve life insurance with new coverage, and this should be explored.\textsuperscript{12}

\section*{§1035 EXCHANGES — CONSOLIDATION AND IMPROVEMENT POSSIBILITIES}

If new coverage is deemed to be superior to existing coverage, §1035 is what allows for exchanges of “like-kind” life and annuity products. This Code section was intended to protect the consumer from being trapped as pricing and product modifications occurred. It allows policy owners to move from one policy to another, with the same or different carrier, as long as certain criteria have been met.\textsuperscript{13}

As existing policies are audited, internal pricing should be examined and then benchmarked against new policy options to determine if a §1035 exchange would improve the policy performance. Examples of improvement include: premium reduction, increased death benefit amount, and extended maturity. It is vital that the ownership be the same in an exchange. It is possible to consolidate multiple policies into one policy, if the policies share the same owner. Further, new policies spread mortality cost over a longer period of time than early policy generations, which can improve costs over existing policies. There can be positive efficiency outcomes through consolidation, if a thorough analysis demonstrates it.

Trustees generally have a fiduciary duty to invest and manage trust assets as a prudent investor would. This includes traditional investment assets, as well as life insurance, which is often overlooked. Today’s trustees can be liable for damages to the trust beneficiaries, perceived or real, and thorough and regular policy reviews are important to the trustee’s fiduciary responsibility. This includes examining §1035 opportunities, even on older policies.

\section*{CONCLUSION}

Today is as ideal a time as ever to review, with a keen eye and sharp pencil, the health of existing life insurance as well as any opportunities to improve upon it. This is driven by an intersection of existing life policy dynamics, new tax law, and today’s lower costs of life insurance. These factors together call loudly for proactive exploration of existing policies and stress testing of funding alternatives to drive superior outcomes.

With the jump in lifetime exemption amounts (the additional $11.2 million), it is a perfect time to review or stress test existing policies (and portfolios) to not only gain clarity on the health of the policy, but to also explore if additional funding alternatives could benefit the trust or policy beneficiaries, from a planning and return on investment (ROI) perspective. This is also true of life insurance policy scenarios where premiums have been utilized for premium payments, e.g., premium financing or split dollar. Exploring the use of new lifetime gifts to pay off such scenarios (loans) makes good planning sense.

Whether it is determined nothing can be improved, or funding existing policies with additional premium to grow the death benefit makes sense, or that a new policy, through a §1035 exchange, is called for — the current life insurance policy owner has a new opportunity, with the recent tax reform, to examine anew their life insurance coverage.

\textsuperscript{12} Id.

\textsuperscript{13} Id.