

Life Settlements: A New Alternative for Troubled Irrevocable Life Insurance Trusts

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With increasing frequency, trustees of irrevocable life insurance trusts (ILITs) are facing the problem of paying life insurance premiums that exceed annual gifts to the trust. A new potential remedy for this situation is a life settlement. A life settlement is the sale of all or a portion of a life insurance policy, generally on an insured over age 65, typically to an institutional investment firm, for an amount exceeding the policy's cash surrender value. Used appropriately, a life settlement can be a tool to help maximize the value of a troubled ILIT.

When gifts fail to meet premium requirements, it may be because of a change in the objectives or financial position of the grantor, but, increasingly, the deficiency is due to policy performance that falls below what was illustrated at the time of purchase. The reason for the lackluster policy performance is the persistent low interest rate environment and, in the case of variable policies, the disappointing performance of the stock market in recent years. For some policies this means paying premiums for many more years than planned, for others, it could mean significantly higher annual amounts of premium, and yet for others, it could be both higher premium amounts and a longer premium payment period.

The problem arises when grantors are unwilling or unable to meet the new premium requirements, which may surpass their financial means or exceed the available annual gift tax exclusions. Trustees are then burdened with the duty of finding an ap-

proach that best protects the interests of the beneficiaries while attempting to satisfy the needs and objectives of the grantor.

The trustee's first step should be to shop for new coverage that falls within the premium budget. Given the advanced age of the typical ILIT grantor, obtaining favorable underwriting may be a challenge. That, together with the potential new policy facing the same low interest rate environment as the current policy and, coupled with new acquisition costs, makes the likelihood of obtaining new coverage on a more favorable basis quite remote.

Assuming new coverage is not a viable option, the trustee could immediately surrender the existing policy to save whatever cash value is available. Alternatively, if the trustee concludes that it would be best to try to maintain the policy, a variety of techniques can be applied. These include loans (from the policy or other sources), surrendering dividends, if applicable, decreasing the policy's death benefit, or electing a non-forfeiture option like reduced paid-up or extended term, if available.

With the advent of life settlements, a trustee has some additional strategies available to maximize the value of the existing policy. In keeping with the trustee's fiduciary duty, the life settlement alternative should be explored as part of the decision making process. The clearest example is where a decision has already been made to surrender the existing policy. If the policy is a candidate for a life settlement, it can pro-

vide significantly more value to the trust than a simple surrender.

Often overlooked, however, is the role a life settlement can play when the trustee would like to keep the existing policy in force. Consider the case of an ILIT-owned \$4 million universal life policy with negligible cash surrender value. The trustee was faced with a new premium requirement to maintain the policy that was double what had been planned. Instead of \$60,000, the new annual premium requirement became \$120,000 and the grantor would not or could not increase the gifts to that level. Without considering a life settlement, the trustee's immediate inclination, in attempting to save the policy, was to cut the face amount in half, thus reducing the annual premium requirement to the original \$60,000, but leaving only \$2 million in remaining death benefit.

A life settlement, however, provided a much better result. With the permission of the issuing company, the trustee was able to split the universal life policy into two: one with a \$3 million face amount and another with the balance of \$1 million. The \$1 million policy was sold in a life settlement transaction for \$250,000. The proceeds from the life settlement provided a large enough cash injection into the remaining \$3 million policy so that the trustee was able to maintain it going forward with the originally scheduled premium of \$60,000. By obtaining a life settlement, the trustee was able to keep \$1 million more death benefit in-force than would have been possible with just a partial surrender of the policy to \$2 million.

This example also illustrates that had the actual insurance need been reduced the \$2 million, the trust would still have been better off selling half the policy in a life settlement transaction, which would have brought \$500,000. Furthermore, if it were determined that there was no insurance need at all, rather than simply surrendering the policy without value, a life settlement could have provided \$1 million in cash.

Finally, if all \$4 million of coverage is actually still needed, a life settlement can still be a creative solution if the estate plan could be served by a survivorship policy instead of a single life policy. The proceeds of the sale of the individual policy in a life settlement could facilitate the purchase of a new survivorship policy for the desired amount of death benefit, \$4 million. The annual premium gift requirement on the survivorship policy could be kept to \$60,000 by using the proceeds of the life settlement for a larger initial premium and/or as a fund within the trust to reduce future premium cash flows to \$60,000.

When considering a life settlement strategy, the trustee should take into account that there may be tax consequences to the life settlement sale. If the proceeds exceed the basis in the policy and the net policy proceeds should be calculated accordingly, but as long as the tax rate is less than 100%, a life settlement should provide additional value for the trust.

Before taking any action that would reduce or lapse an existing policy, the trustee should investigate the possibility of a life settlement. Without this type of appraisal, substantial opportunities to minimize the impact of premium gift shortfalls and improve the position of the trust may be overlooked.

There is a common perception that a life settlement is fundamentally a tool to salvage the most from a policy about to be lapsed or surrendered; a life settlement is, in effect, a detriment to the heirs who would stand to gain much more if the policy were left intact. This is true in many life settlements because the policy owners decide they need the money for themselves now, rather than for their heirs sometime in the future. In the case of a troubled life insurance trust, however, just the opposite can be true. A life settlement can provide a new and innovative solution to preserving and maximizing the value of a life insurance trust for its beneficiaries.▲