

# Robin & Peter on LIFE SETTLEMENTS



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## **The TCJA Changed Some Trust Clients Needs for Life Insurance - Here Are 5 Ways to Respond**

The Tax Cuts and Job Act of 2017 (TCJA) doubled the already sizeable estate tax exemption. In 2018, indexed to inflation, the exemption is \$11.2 million per individual and, with portability, \$22.4 million for a married couple. This change reduces, by about two-thirds, the already small number of estates that will have to pay federal estate taxes. It is estimated that now only about 1,800 estates, annually, will be subject to this tax. Additionally, even those remaining estates still hit by the estate tax will see significantly lower tax liabilities.

The Irrevocable Life Insurance Trust (ILIT) has long been a fundamental strategy for managing federal estate tax liabilities. The popularity of the ILIT for estate planning purposes stems from its ability to shelter the proceeds of the life insurance owned by the trust from estate taxes while giving the grantor the ability to direct, in the trust document, how the proceeds are to be used and for whom.

A relatively small annual gift of the premium amount can be leveraged into a large liquid death benefit at precisely the time cash is needed to pay estate taxes and to preserve the assets of the estate. As a result, ILITs can be used to efficiently pass significant amounts of wealth to the grantor's beneficiaries free of not only estate taxes, but income and capital gains taxes as well.

Due to the substantial reduction in estate tax liabilities, many of these trusts, created for the purpose of offsetting estate taxes, are no longer needed. ILITs are sometimes created for other reasons other than taxes or can be repurposed, but many of these trusts may no longer be wanted.

Being irrevocable, these trusts cannot simply be unwound. However, the grantor of the trust may determine that the trust or the insurance in the trust is no longer needed. The grantor can effectively shut down the trust by ceasing to make gifts to the trust that can be used to pay premiums. Faced with this situation, the trustee needs to decide on a course of action that will comply with the terms of the trust and, first and foremost, protect the interests of the beneficiaries.

When a trustee no longer has the cash coming in to pay the premiums for a policy, it will inevitably lapse. This leaves the trustee with the question of what action to take to maximize the remaining value of the policy for the trust. The trustee has several alternatives:

- 1) ***Continue the policy at the current face amount.*** Most policies, other than term, usually have some feature by which the death benefit can be extended at the current face amount for a period of time. For whole life, this would be the extended term non-forfeiture option and, for universal life, until the cash value runs out. This approach succeeds if the insured dies before the expiration of the death benefit, but otherwise leaves the trust beneficiaries with nothing.
- 2) ***Continue the policy at a reduced face amount.*** Whole life policies offer a reduced paid up insurance option and universal life generally allows policy owners to reduce the death benefit. This could provide a residual value to the policy owner no matter when the insured dies. The trustee must consider that the reduced death benefit is likely to be significantly lower than the original face and is only received at some unknown future time when the insured dies.
- 3) ***Borrow the premium payments.*** In the case of a life insurance trust, there are rarely significant assets in the trust other than the insurance policy. This could make financing the policy from third parties difficult, but the beneficiaries might be willing to lend the trust funds to pay the premium. Loans from beneficiaries can be problematic, however, where they don't all agree or can't all afford to make the loans. Additionally, although fairly commonly permitted, the trustee should determine if the trust powers allow for borrowing.
- 4) ***Surrender the policy.*** For whole life and universal life policies, whatever cash surrender value there may be can be preserved by surrendering the policy.
- 5) ***Investigate a life settlement.*** Too often overlooked, a life settlement could bring more value than surrendering the policy and should be compared to the other strategies as well. Most importantly, for term policies that are convertible to universal life, a life settlement might be the only option that salvages any value at all. Before pursuing a life settlement, the trustee should

determine if the trust permits the sale of a policy, though such restrictions are not common. It is also possible to sell the policy to one or more of the beneficiaries, but since all of the beneficiaries don't necessarily have similar objectives or adequate resources, that approach rarely works out. However, should that be considered, investigating a life settlement, if nothing else, will offer a good indication of the fair market value of the policy.

TCJA has significantly reduced federal estate tax liabilities leaving many ILIT grantors ambivalent about continuing to fund insurance policies that were purchased to offset estate taxes. Should it be determined that the policy will no longer be funded, trustees can choose from a variety of strategies, but too often, especially with term policies, the life settlement option isn't even considered.

As you review your clients ILITs and it is decided that a life insurance policy is no longer needed, wanted or affordable, it's your responsibility to act in the best interests of your clients. A life settlement may be the most lucrative alternative to lapsing or surrendering a policy and should be presented as an important option.

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