

## A MATTER OF PERSPECTIVE: INSURANCE

By Richard L. Harris



# Issues and Trends Affecting Life Insurance Performance

Court settlements, poor servicing of policies and low interest rates marked 2018

There were two settlements in 2018 that had significance for the life insurance industry: *Cahill v Commissioner*,<sup>1</sup> regarding intergenerational split dollar, and the class action lawsuit against the John Hancock Life Insurance Company<sup>2</sup> (Hancock) regarding its raising the cost of insurance rates on certain classes of policyholders. In addition, we saw trends emerge regarding the servicing of life insurance policies related to commercial loans to finance policy premiums, existing split-dollar plans and the effect of the low interest rate environment on policy performance.

### *Cahill*

*Cahill*<sup>3</sup> was a case about economic benefit intergenerational split dollar. For a quick refresher, intergenerational split dollar is when Senior sets up a trust to insure Junior for the benefit of Junior's children. Senior then (in this case) advances a single sum to pay the premium on the life insurance policy. The advance is repayable at Junior's death. Assume Senior dies first, and Junior may have a life expectancy of 30 or more years. What's the value of that receivable in Senior's estate if the repayment is uncertain, there are no current repayments and, in all likelihood, the repayment won't be made for 30 years or longer? This is in essence what happened in the *Cahill* case.

In *Cahill*, the estate valued a \$10 million receivable at \$183,700, less than 2 percent of its face. The policy had a cash surrender value (CSV) of approximately

\$9.6 million. Richard Cahill, the senior in the above scenario, set up a trust that borrowed \$10 million from an outside lender to fund the transaction. The loan was repayable in five years. The Internal Revenue Service argued that the real value of the receivable was the CSV of the insurance policy.

In an unusual settlement (unusual in that it was published), the estate conceded the IRS' value and paid taxes and a 20 percent undervaluation penalty in exchange for the IRS conceding discounts on other unrelated notes payable to the estate. Obviously, the IRS didn't like this transaction—they're getting whipsawed between split-dollar regulations and fair market value. The Tax Court, however, pointed out that the split-dollar regulations, Treasury Regulations Sections 1.61-22 and 1.7872-15, relate to income and gift tax purposes, not estate tax. *Cahill* is unfortunately a case of bad facts.

I have a postscript. There's one thing about the case that I'm unsure of—in the end, did the transactions cost the estate money, or did it save the estate money? The result hinges on whether the estate would have received the other valuation discounts if the discounts were all that the IRS had questioned. If the estate wouldn't have received the discounts, then the taxpayer's result in *Cahill* was worth it. Here's my analysis:

The \$10 million note payable would be a debt of the estate, reducing the value of the estate by \$10 million. This leaves a \$9.6 million value for the receivable, less that \$10 million—reducing the estate by \$400,000. That reduction saves \$160,000 in estate taxes. Yes, the estate would owe that \$10 million plus interest, and the cash value to pay the note left a shortfall. With interest, let's approximate \$600,000. That still leaves the estate \$440,000 in the hole (\$600,000 - \$160,000). The estate would still have to pay the undervaluation



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penalty of approximately \$752,000. The estate has lost \$1.192 million (\$440,000 + \$752,000). However, the IRS, in denying the discounts for any of the receivables, asked for a total of \$8,546,400 in taxes and penalties. The tax and penalty on the intergenerational split-dollar transaction alone was \$4.512 million. That leaves a difference of \$4,034,400 in the estate's favor. Deducting the loss of \$1.192 million, there's a net gain of \$2,842,400. This analysis is predicated on the idea that the IRS would have won all of its arguments about the value of the other receivables. It also doesn't take into account the legal fees (presumably deductible as an estate expense) that were paid to adjudicate the matter.

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What did the IRS get in return? Bragging rights to proclaim publicly about its win against an intergenerational split-dollar transaction. However, there are still two other cases pending that haven't been settled—*Morrisette* and *Levine*. All three of those cases are about economic benefit split dollar, not loan split dollar.<sup>4</sup>

### The Hancock Settlement

A class action lawsuit was filed against Hancock because the company had raised the cost of insurance (COI) charges on a class of primarily older insureds on some of their universal life (UL) policies, even though mortality rates had declined. The parties filed a July 20, 2018 motion for a settlement, in which the presiding magistrate's recommendation to the court would result in Hancock paying over \$91.25 million to the plaintiff class.

Why did Hancock find itself in the position of having to raise the COI? COI is based on mortality of the insureds, not on anything else. The only reason an insurance company can raise the COI is because it's been

experiencing deaths earlier than originally projected. Insurance companies have the right to raise those costs up to a predefined maximum disclosed in the policy. Many policies were sold with guaranteed minimum rates of return. With the decreasing interest rates, the insurance companies have found their profits squeezed, in part by those guarantees.

Despite the common sense understanding of what COI means, COI as defined in an insurance policy, however, may not be limited to just adverse mortality. In effect, the carrier can raise those costs for any reason.<sup>5</sup> Most individuals don't read their insurance policies, and most agents don't go into a detailed explanation of the policies' terms. Many people buy insurance because they trust what an insurance agent is telling them. In the Hancock case, this led the magistrate to look at the plain meaning of the terms of the policy.

Other insurance companies have similarly targeted large policies on the lives of now-older people. These companies created policies priced to sales and now want to make the policies more profitable. Transamerica was the first company to raise those rates, which triggered a class action. The plaintiffs reached a settlement. Additionally, whole life policies sold by mutual insurance companies make implicit assumptions—that is, assumptions that aren't spelled out to the policyholders. They have the dividend as a mechanism to make adjustments that aren't publicly disclosed. One company, Phoenix Mutual, which was taken over by Nassau Re, has drastically reduced its dividends on in-force policies without having to disclose why it did it. (Obviously, it's profit. Nassau Re was formed by a private equity firm.)

### Policy Servicing Issues

All life insurance policies need someone to mind the store for the owner and/or insured. This issue has become more acute with UL policies. Additionally, more complicated strategies for paying premiums compound the problem.

As previously mentioned, low interest rates have affected the profitability of insurance companies and the dividends of participating policies. Further, unless ongoing premiums are being paid and the agent is receiving some compensation, the incentive for agents to service UL policies isn't there. Finally, the turnover in the industry exacerbates the problem.

UL policies are in reality flexible premium policies.



That means that a client can decide how much to pay in premiums. Unless the client purchases a guaranteed UL (GUL) policy and pays the required premiums on a timely basis, there's no guarantee that the policy will work as originally projected. In fact, all other UL policies are guaranteed NOT to work as originally projected. (GUL policies also need to be monitored to make sure that those premiums have been paid.) For other UL policies, what your client elected at the outset based on an illustration when issued may not be sufficient currently to fund the policy for the original time expected.

Variable UL (VUL) performance is based on underlying investments called "subaccounts." Most of these are invested in stocks and/or bonds. Management of a policy is more important here. Clients with VUL policies in 2008 to 2009, when the market had a severe downturn, who got scared and selected a more conservative allocation, experienced three things: (1) they solidified their losses; (2) they didn't participate in the eventual rise of the markets; and (3) those with a more conservative portfolio may now be unable to reach the original policy projections because the subaccounts can't produce those returns.

Indexed UL policies are the most complicated of the lot. The formula to determine how much of an index will be credited can change monthly for new money going in or previous money being reinvested. Assumptions were also made about the performance of these policies. Before the National Association of Insurance Commissioners stepped in, companies were unconstrained as to what rate they could project. That changed with Actuarial Guideline 49, which prescribed a formula to determine the maximum rate that can be charged. Here's how these policies work: The insurance company buys various options on indexes each month that in part determine the crediting rate for that tranche of money. One of the factors in purchasing those options, other than their price, is the interest rate the insurance company is earning. Because they're guaranteeing a minimum rate (usually 0 percent), they have to hold part of their earnings back to support that guarantee. The rest of the money is available to purchase options. The decline in interest rates has limited the amount of money available to purchase the options, hence reducing the maximum rate of return the carrier will credit.

## Funding Methods

Other than paying premiums directly, there are two ways to fund policies: borrowing from a commercial lender or personally advancing or loaning the money (split-dollar arrangements). There are individuals who used commercial lenders to finance their policies but no longer have someone to manage the lending going forward. The original loans were typically for five years, while the lending strategy required either more loans after five years or the existing loans to continue until a time when they can be paid off. In many cases, the anticipated payoff date is the death of the insured, which means these loans have to be managed for many, many

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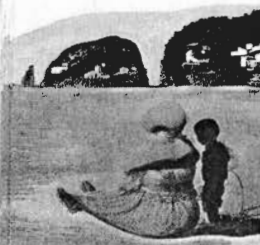
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years. This long timeframe requires borrowers to meet new lending requirements and negotiate new loan terms every time they need to renew. Remember, a commercial lender will never make a loan that bears any risk of loss. This means that the borrower has to keep providing collateral for any shortfall between the value of the policy being financed and the CSV of the policy.

In split-dollar arrangements, apart from policy performance, there are things that can go wrong and need to be monitored. If the economic benefit arrangement is used, there's a taxable value to the insurance protection provided to the owner of the policy. This value is based on the difference between the greater of premiums paid or the cash value (I'm excluding old equity split-dollar arrangements still in existence) and the face amount of the policy. For example if there's a \$20 million policy, the premiums paid to date have been \$3 million and the cash value is less, the amount at risk is \$17 million, and that amount is multiplied by the appropriate taxable term rate, usually Table 2001.

There are several potential problems with this arrangement. One is that the amount that's owed




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becomes larger so that more of the proceeds are back in the funder's estate. Another is that the taxable term (Table 2001) cost goes up every year, even if no premiums are paid—to a point where even if premiums are being paid, the taxable amount is greater than the premium. Finally, some insurance companies are taking a very liberal interpretation of what they can use as their “published” rates. I’ve seen one offering both its own published rates and Table 2001, telling the tax professional to decide which one to use. This is problematic, because unless a tax professional is very knowledgeable about split-dollar arrangements, he might not be aware that a provision of Notice 2002-8 (the Notice) is still in effect. This provision states that for a carrier to use its own term rates, it must regularly offer and sell those rates through its normal distribution channels. I looked at products offered that met the Notice’s requirement, and John Hancock didn’t offer such a product.

If the economic benefit split-dollar arrangements aren’t terminated, they can be converted to a loan split-dollar arrangement. The actual fair market value of the policy must be used for tax purposes in case of termination or conversion, which isn’t necessarily the amount of the advance or the CSV. There’s an antiquated regulation (Treas. Regs. Section 25-2512-8) that offers a formula that can be used, but especially in the case of GUL policies, the result may be ridiculous. Instead, a qualified appraisal may be needed.

Loan split-dollar arrangements present a different set of issues. Are there multiple loans and/or existing loans that mature and have to be reset at current interest rates? Unless someone did a lump sum loan for the life of the insured at the outset, that will be the case. Even if the individual loans are for the life of the insured, each loan has to be accounted for and tracked separately, and this accounting may have to be reported to the IRS. Is interest being paid or accrued? If it’s being paid by gifts, are the funds not directly related to the amount of the interest? If the funds are directly related to the amount of interest, Treas. Regs. Section 1.7872-15 disregards them and calculates tax as though the gift hadn’t been made—a potential for double gifting for the same purpose. But, interest rates have been rising. Is the ongoing cost getting to be too high? If interest is accruing,

is the amount due back to the lender so large that it partially defeats the purpose of the insurance? 

### Endnotes

1. *Estate of Richard F. Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).
2. *37 Bensen, Parkway, LLC et al. v. John Hancock Life Insurance Company (U.S.A.)*, Civil Action No. 15-ev-9924 (S.D.N.Y. filed Dec. 22, 2015).
3. There’s been a lot written on this case. See Steve Leimberg’s *Estate Planning Newsletters* and the National Association of Estate Planners & Councils website.
4. In Steve R. Aker’s June 28, 2018 white paper for Bessemer Trust about the case, Aker notes a settlement for a 65 percent discount on a loan transaction and that “other planners acknowledged that discounts are lower under the loan regime approach, but only nominally so.” See [www.bessemertrust.com/sites/default/files/2018-08/Cahill\\_Summary\\_Website%20%281%29.pdf/](http://www.bessemertrust.com/sites/default/files/2018-08/Cahill_Summary_Website%20%281%29.pdf/)
5. Personally, this disturbs me. While there are many changing variables that affect the performance of a policy, I think that by taking such actions, insurance companies have violated the trust policyholders put in them.



### SPOT LIGHT

#### Flower Power

*Jeune fille dans le jardin de Giverny* by Claude Monet sold for \$16,062,500 at Christie’s Impressionist and Modern Art Evening Sale Including Property from the Collection of Herbert and Adele Klapper on Nov. 11, 2018 in New York City. Monet’s desire to document the French countryside led him to paint the same scene over and over to capture the changing light and seasons.