

TAX - MOTIVATED LIFE INSURANCE: " AN EXCITING AND HELPFUL TOOL "

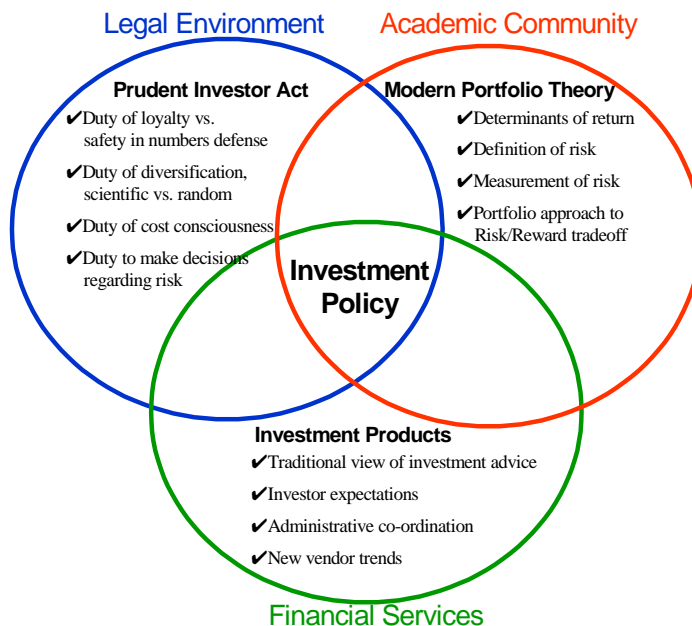
What do the following programs have in common?

- ◆ Tax arbitrage single-pay life insurance
- ◆ Minimum deposit life insurance
- ◆ Section 79 Group permanent insurance
- ◆ Retired Lives Reserve
- ◆ Split dollar and reverse split dollar insurance
- ◆ Corporate Owned Life Insurance (COLI)
- ◆ 419A(f)(6) Welfare Benefit Trust insurance

The seasoned attorney may recognize that these programs are all "tax-advantaged" insurance products. Some products date as far back as the 1950s and constitute an important percentage of product sales for major insurance carriers. Unfortunately, like the Clifford Trust tax shelters that became extinct when the grantor trust rules changed, many of these "exciting and helpful" tools have also disappeared from the financial landscape¹. This is, on its face, not remarkable because frequent changes in tax law require modification or abandonment of noncompliant planning strategies.

A Persistent Pattern of Abuse?

What is remarkable, however, is the argument advanced by Joseph M. Belth, Professor emeritus of insurance at the University of Indiana, in the introduction to a recent article. Belth's article reports on court rulings upholding the IRS position that Corporate Owned Life Insurance (COLI) plans used to pre-fund medical benefits for retired employees are nothing



more than sham tax shelters². Belth implies that COLI is merely the most recent example of a persistent pattern of insurance industry marketing schemes that have left customers holding the bag for billions of dollars in lost tax benefits as well as wasted product acquisition costs and plan design expenses. Specifically, Belth alleges that:

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INSURANCE INDUSTRY HIT BY FINANCIAL, LEGAL SHOCKWAVES

On September 6, 2002, Moody's Investor Service downgraded its outlook for the U.S. Life insurance industry from stable to negative. On September 19th, Fitch Rating Service announced ratings downgrades for 42% of its life insurer ratings universe. These events have not been well publicized, either to the general public or to insurance salespeople. The Society of Financial Service Professionals e-Bulletin (September 25, 2002) contained a report from the Weiss Rating Service (Weiss Ratings Inc.) that the "nation's life and health insurers recorded a \$4.5 billion profit for the first three months of 2002, representing a \$1.1 billion, or 32.8% increase over the same period last year...." This bulletin is sent to insurance agents with CLU or ChFC designations.

Independent analysis of the life insurance industry paints a potentially bleak picture for both company shareholders and insurance policyholders. A portion of this picture came into

focus in August, when Moody's released a special report entitled "Troubled Credits: Pressure on the US Life Insurance Industry and its Ratings Increases." In this report, Moody's analysts voiced concern over the exposure of many insurers to corporate bond defaults by the following ten corporations:

- ◆ Enron
- ◆ Kmart
- ◆ WorldCom
- ◆ Qwest Communications
- ◆ The Williams Companies
- ◆ Tyco International
- ◆ Dynergy
- ◆ Global Crossing
- ◆ Xerox Corp
- ◆ Adelphia Communications

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Life insurance is a price sensitive product (price elastic). The lower the price (technically, the closer the premium cost to the actuarially fair value of the protection), the greater is the demand for the product. This runs counter to the conventional wisdom that insurance is sold rather than bought and that high commissions are necessary to reward agents for convincing their customers to do the right thing.

...a proper analysis seeks not to determine how much a life insurance policy will add to a family's net worth, but rather, how much wealth will an insured hedge position subtract relative to a forced sale of illiquid assets to pay estate transfer costs.

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- ◆ Prominent life insurers, aided and abetted by creative and aggressive promoters, hire accountants, actuaries, attorneys, and others to develop and market "tax-motivated life insurance products."
- ◆ These products represent "sophisticated assaults on the United States Treasury," forcing the IRS to scrutinize their legality; and, where current tax law is insufficient to put a stop to abusive tax shelters disguised as life insurance programs, to encourage Congress to pass restrictive legislation.
- ◆ As a result of Congressional action and court rulings, insurance buyers may not only fail to realize tax benefits promised by the sales agent, but also may owe substantial penalties and interest because deductions or exclusions rest on speculative interpretations of tax rulings.

This article seeks to:

- 1) Provide additional perspective on Belth's assertions;
- 2) Comment on current tax-motivated insurance marketing efforts; and,
- 3) Suggest appropriate actions for trustees and legal counsel in light of the current regulatory environment.

Consumer Demand for Life Insurance

One of the basic principles of insurance is that the carrier must collect a sufficient amount of premiums so that, in conjunction with investment earnings thereon, it has adequate funds to pay expenses (including claims) and to achieve the required return on owners' capital. This means that, in a statistical sense, the present value of premiums that you pay to an insurance carrier are higher than the present value of benefits that you are likely to receive. Technically, from the perspective of the insurance buyer, the expected net present value of any insurance product (auto, home, life) must be negative; and, from the perspective of the insurer (and the regulators that oversee company solvency), the expected net present value of any insurance product must be positive.

This economic fact of life is in no way an argument against buying insurance to hedge unacceptable economic risk. Other than gamblers who exhibit inverted risk aversion curves (the thrill of the risk compensates for the expectation of loss), risk averse investors derive positive utility from paying money to avoid unnecessary gambles. The unique slope of each investor's risk aversion curve determines the amount that they are willing to pay. Risk-neutral investors will acquire insurance coverage only if it is

free (or employer paid). Highly risk averse investors are willing to pay substantial premiums to mitigate certain economic risks. Investors purchase put options to protect accumulated wealth; life insurance buyers pay premiums to hedge against lost income in the event of early death, or to hedge the financial consequences of forced asset liquidations when settling an estate or unwinding a business arrangement.

Two consequences flow from the basic principle of insurance:

- 1) Life insurance is a price sensitive product (price elastic). The lower the price (technically, the closer the premium cost to the actuarially fair value of the protection), the greater is the demand for the product. This runs counter to the conventional wisdom that insurance is sold rather than bought and that high commissions are necessary to reward agents for convincing their customers to do the right thing.
- 2) Absent special tax considerations, any hedge instrument, such as protective puts or insurance contracts, must systematically subtract value from the owner's estate. This runs counter to the oft-heard sales pitch that life insurance enables estate taxes to be paid with "discounted dollars."

Indeed, a recent and valuable book published by finance professors at York University in Toronto and Concordia University in Montreal, points out that, if you are fortunate enough to possess a large and liquid estate, the purchase of a life insurance policy to fund estate transfer costs is "simply prepaying your kids' tax bill. If you want to, go ahead, but the net present value of the strategy will be negative."³ Thus, from the perspective of estate liquidity planning, a proper analysis seeks not to determine how much a life insurance policy will add to a family's net worth, but rather, how much wealth will an insured hedge position subtract relative to a forced sale of illiquid assets to pay estate transfer costs.

Enhancing Consumer Demand Through Tax Arbitrage

Life insurance, because it is price elastic, becomes more attractive in the marketplace if the government subsidizes its purchase. As a matter of public policy, the government subsidizes home ownership (deductibility of qualifying mortgage interest payments) and life insurance (tax-deferral of gains on the increase in policy cash value, and exclusion of qualified death proceeds from income taxation). Grant-

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Milevsky and Gottesman define tax arbitrage as "the science of taking investment positions that capitalize on quirks or inefficiencies in the income tax code."

ing the life insurance contract preferred tax status in order to promote public policy goals is not, however, the same as granting the insurance industry a license to develop and promote tax arbitrage strategies. Milevsky and Gottesman define tax arbitrage as "the science of taking investment positions that capitalize on quirks or inefficiencies in the income tax code."⁴ Tax-motivated insurance products appear relatively benign, because they appear to be rooted in the accepted belief that taxes are a patriotic way to support the country, but only a fool pays more than necessary. Viewed from a wider historical context, there is evidence to suggest that Belth's hypothesis regarding a long-term pattern of financial harm to insurance policy owners because of adverse governmental reactions to aggressive, and perhaps abusive, marketing schemes is not so farfetched.

Irrespective of the motives ascribed to life insurance manufacturers and promoters, if the consequence of their historical behavior is to have engendered a tax-sensitivity within Courts, Congress and the Treasury Department, that fosters a proclivity to scrutinize tax-motivated products, and creates a bias against such products, then acquisition of tax motivated insurance may generate unacceptably high levels of tax, audit and economic risk. Ironically, a successful process of designing, marketing and implementing tax motivated insurance products may contain the seeds of its own destruction.

**An Historical Example:
Marketing Goals and IRS Reactions**

Consider, for example, the marketing of corporate-sponsored tax-deductible group life insurance. The history of tax-favored group insurance can be traced to 1920 (Law Opinion 1014) affirming that employer paid premiums on "group life insurance" are not reportable compensation to covered employees⁵. Whereas Law Opinion 1014 did not distinguish between term and permanent policies, insurance carriers began to market "group permanent" insurance as well as "group term" insurance contracts. By 1960, however, the Treasury stated that group permanent insurance triggers reportable income because increasing cash values, as well as the right to receive continuing paid-up coverage, provide substantial economic benefits. At this point, a pattern of insurance company marketing action followed by adverse IRS/Congressional reaction accelerates along two differing tracks.

Track one follows the group term insurance path. Basically, it sees the insurance industry promoting a variety of programs designed to provide minimum coverage to rank and file employees while, concurrently, insuring key execu-

tives and business owners with large amounts of tax-deductible term insurance coverage. The design and marketing strategy is known as "superimposing." The 1963 hearings before Congress on the Presidential recommendation to pass IRC§79, point out abusive actions by small businesses and professional corporations that purchase minimum coverage for one or two full time employees and superimpose jumbo face amounts on the lives of the principal(s). In Congress' view, such actions constitute a government subsidized insurance purchase plan for the wealthy, not a valid employee benefit plan. With the passage of IRC §79, the excludability from reportable income of group term insurance premiums was limited to the first \$50,000 of coverage per insured employee. Beyond \$50,000, a government table (Table I) measures the economic benefit of the term insurance coverage. Furthermore, as time passed, firms with less than ten employees had to meet more restrictive conditions for premium deductibility. However, if a group term program met all applicable regulations and Code provisions, the aggregate premium costs (even for coverage in excess of \$50,000 per employee) remains a deductible business expense. Despite Congressional legislation to eliminate some nettlesome abuses, the games were about to begin. While we could describe further the ongoing ingenuity of the insurance industry's promotional and marketing efforts in the group term area (for example, some carriers set up multiple employer trusts in states with favorable regulatory provisions in an effort to bypass the federal tax regulations for under 10 employee firms), instead we turn to track two, which follows the group permanent insurance path.

After 1960, the story of group permanent sees the insurance industry aggressively marketing various business insurance programs that have little or no economic advantages, except for certain tax benefits. Basically, the superimposing strategies remain in play with the insurers maintaining that a bona fide group plan can consist of either a single master group contract or multiple individual contracts. In this case, carriers design plans that superimpose individual whole life contracts covering only the "class" of executive employees onto the group master contracts covering rank and file employees. Actuarial gamesmanship appears in a number of forms. For example, once an individual cash-value contract was "qualified" as group insurance, if the carrier allocates most premium costs to the term component, then several advantages follow:

- 1) The preponderance of the premium costs is a deductible business expense;

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- 2) The insured's tax costs are capped by the Table I measure of economic benefit;
- 3) The increase in policy cash value represents a double tax benefit, because economic value is transferred from the corporation to the insured without triggering tax liability, and, because the increase in policy cash value is not reportable.

Early attempts to qualify individual whole life policies as group insurance used allocations based on combinations of decreasing term and annuity products with little or no mortality component attributed to the annuities. As the IRS proceeded to issue a series of pronouncements regarding permissible and impermissible policy allocations, tax consequences of dividends, and other issues, a range of unresolved issues remained. Among these were the applicability of Table I rates to group permanent coverage and the applicability of superimposition of group permanent programs within the marketplace of firms with less than 10 employees. If a president of a firm with less than 10 employees superimposed a permanent cash-value insurance contract with an aggressive actuarial allocation, the illustrated economic benefits, however attractive, might trigger substantial future tax penalties.

Legal gamesmanship did not take a back seat to actuarial gamesmanship. Informed commentators became increasingly alarmed over the possibility of adverse governmental reaction to aggressive marketing programs that focused on tax benefits. The opening paragraph of one CLU Journal article typifies the admonitory tone:

*"In reviewing the many articles that have appeared in the CLU Journal and other periodicals over the last few years concerning group ordinary life insurance, it is striking to note the contrast between the caution of the authors and the relative lack of caution with which the product is marketed."*⁶

The magnitude of tax benefits is largely a function of the allocation of insurance policy components between mortality costs and cash value credits. Allocations with little economic reality turn cash value increases into business tax deductions. Furthermore, several authors condemn a perceived misuse of private letter rulings with at least one suggesting that insurance carriers provided limited and biased data to the IRS on behalf of selected clients (e.g. allocations between term and permanent for a firm with a young employee population) to receive a favorable ruling. The carrier would then initiate a broad-scope marketing campaign based on an "approved product."

On May 14, 1979, the IRS issued final regulations regarding the tax treatment of group permanent insurance. Under the new regulations, at least ten employees (working for a single employer) must receive life insurance coverage for an insurance program to qualify as group insurance. The allocation between group term and group permanent insurance costs must be in writing (i.e. benefits must be separately stated within the policy) and the allocation must follow reasonable formulas. The cost of permanent insurance includable in a covered employee's reportable income is calculated according to a formidable formula that determines net single premiums based on specified mortality and interest factors. The 1979 regulations eliminate the tax advantages of group permanent policies. Limited grandfathering provisions applied to policies in effect on November 4, 1976. Not surprisingly, within a short time, the group permanent product, which promised tax-advantaged wealth transfers from the corporation to the shareholder, disappeared from the market.

IRS Imposes The Death Penalty: Retired Lives Reserve

The story of §79 insurance does not end in 1979, however. Certain insurance industry practices (policy allocations without substance, "cherry-picked" private letter rulings, speculative interpretations of revenue service rulings, etc.) put Congress and the IRS into a defensive position that ultimately forced them to levy the death penalty for one of the most popular business insurance programs: Retired Lives Reserve. A Retired Lives Reserve (RLR) is a fund established to provide continued group term life insurance coverage for retired employees. The reserve is pre-funded over the employee's working life. Employer contributions, according to the insurance marketers, would be tax-deductible business expenses (under IRC §162(a) provided that the reserve is funded on a level actuarially determined basis); earnings within the fund would accumulate tax free (under employee benefit plan rules if held in an exempt trust or if held in life insurance or annuity contracts: IRC §101(a)); and employer contributions for coverage under \$50,000 would not be reportable income to covered employees (under IRC §79). Most carriers offering a RLR product structured the program as a deposit administration contract in which the reserve had no associated mortality costs. Additionally, when the employee retires, all tax liability would disappear under the provisions of IRC§79(b)(1) which specifies that retired employees do not have to include employer payments for group insurance coverage in reportable income.

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RLR was, in many respects, the ultimate in tax-leveraged insurance products. One CLU Journal article compared the after-tax employee cost (from ages 50 through 75) for \$100,000 permanent insurance coverage under four purchase methods⁷:

- ◆ Split Dollar: \$36,474.50
- ◆ Life Paid-Up at 65: \$34,425.00
- ◆ Group Permanent: \$22,359.50
- ◆ Retired Lives Reserve: \$5,115.00

In 1983 the IRS, in a Technical Advice Memorandum, said that RLR funds used for premium payments on insurance for retired employees represent a non-forfeitable right by the employee in the fund. The value of this right must be included in the employee's income in the year of his or her retirement. Additionally, the IRS announced that the RLR programs were under "extensive study" and that no further rulings would be issued.

In 1984, new regulations under the Deficit Reduction Act stated that a plan providing post-retirement life insurance or medical benefits must meet the nondiscrimination requirements applicable to Welfare Benefit funds. These regulations restrict discrimination in favor of highly compensated employees and provide that the employer may be subject to an excise tax equal to 100% of the postretirement life insurance benefit provided to employees under a discriminatory plan. Additionally, postretirement benefits with respect to key employees require separate accounts and funding for such benefits must be paid only from the separate account. The Conference Committee Report to the Deficit Reduction Act provides that plans offering insurance benefits exclusively for retirees are considered to be deferred compensation. The effect of this ruling is to limit the deductibility of employer contributions to the amount includable in the employee's income (IRC §404(a)(5)). The new regulations spelled the demise of RLR and employers were left with "hot potatoes" that required, in some cases, administratively costly solutions such as establishment of Voluntary Employee's Beneficial Association (VEBA) Trusts. Amounts allocated to "key employee" separate account were treated as contributions to employer-sponsored pension plans with the result that RLR contributions had adverse consequences on eligibility for retirement savings benefits. Discriminatory plans were subject to a 100% excise tax.

Marketing Strategies: Stretching Tax Benefits Beyond Public Policy Bounds

The insurance industry has come to rely on purchases of tax-motivated insurance plans

marketed as tax-deductible pension insurance, non-qualified deferred compensation, split dollar insurance, and various other methods that promise tax benefits to employers, employees or both.⁸ In many cases, the purchase economics make sense only in the presence of tax benefits. Furthermore, if such benefits prove to be mere chimeras, the economic consequences of the transaction may be catastrophic. The history of corporate-sponsored group insurance exhibits a pattern of marketing actions, followed by Congressional and Revenue Service reactions, resulting in financial jeopardy for purchasers of the insurance programs. It is significant that this pattern is not limited to employer-sponsored plans. An equally rich set of examples can be drawn from a history of the marketing of tax-favored individual insurance purchases. There is a clear path from the marketing, in the 1950s, of single-pay insurance purchased with borrowed funds (tax favored build up of inside cash values combined with deductibility of interest for borrowed funds); to limited pay insurance purchased with borrowed funds; to non-systematic borrowings from annual premium insurance policies under Minimum Deposit plans; to Zero-Pay Minimum Deposit (marketed, by some companies, under the heading "Government Pay All")⁹; to the final Congressional disallowance of interest deductions for non-qualifying personal debt. Despite significant legal questions regarding the validity of interest deductions for loans secured merely to pay currently due interest on outstanding debt obligations, the insurance industry continued to market tax motivated insurance purchase plans to individuals. Many consumers were left with highly leveraged insurance contracts which, following the Tax Reform Act of 1986, became too expensive to continue. Sadly, consumers discovered that policy surrenders or lapses generated fully taxable income if policy debt exceeded their tax basis. Insurance agents, encouraged by home offices that provided them with computer-generated illustrations, sold tax benefits (deductibility of interest) but failed to provide adequate information about potential tax liabilities. Common to many tax arbitrage strategies is the attempt to extend the "tax-shield" of annuities and insurance beyond their customary bounds. Equally common, is the final result, which finds an unfavorable response by the Courts, IRS or Congress.¹⁰

Current Product Marketing: Policy Benefits vs. Audit, Tax and Economic Risks

The insurance industry's ongoing reliance on tax-motivated purchases continues to fuel current marketing programs such as informal

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Recent proposals to reevaluate some of the basic tax characteristics of cash-value life insurance are troublesome for buyers of tax-motivated life insurance.

Assets that are wrapped in tax-arbitrage plans such as split dollar agreements or that have poor economic viability absent certain future projected tax benefits may not be suitable investments for the trust portfolio.

funding of non-qualified deferred compensation programs through corporate-owned life insurance and Welfare Benefit Trust (WBT) insurance programs. Responses to aggressively designed and implemented plans are predictable—the IRS, for example, announced that corporations maintaining a Welfare Benefit Trust (under Code §419A(f)(6)) must register the plans according to the disclosure requirements for corporate tax shelters. The IRS has seen fit to litigate a number of WBT cases with mixed success. Despite a host of unresolved issues (DOL position on funding benefits through cash-value insurance, measurement of the economic value of pre-retirement death benefits, etc.)¹¹, some vendors continue to promote their programs.

The Revenue Service's attacks on certain COLI programs are based, in part, on misallocations of mortality, interest, and expense components within policies with the result that the transactions are devoid of economic substance and have no business purpose beyond the generation of corporate tax deductions. This is the same battle that the insurance industry fought and lost in the 1970s in the Section 79 group permanent arena. In COLI, actuarial (mis)allocations transmute non-deductible corporate premiums into deductible interest expense.

Professional advisors have an obligation (in some cases a fiduciary duty) to help clients structure economic transactions so that they do not incur unnecessary tax liabilities. This general principle is sometimes twisted to imply that advisors have an obligation to help clients generate maximum current tax deductions. Although these objectives may sound similar, they are, in fact, very different. Given the history of catastrophes that have befallen purchasers of many tax-motivated life insurance programs, it is clear that advisors must carefully weigh the merits of a current deduction against the liabilities of increased audit and tax risk. A reasonable observer can conclude that the risks for buyers of tax-motivated insurance have increased substantially. If anything, the hair-raising complexities of certain insurance proposals have increased to the point where the promoter either stretches the insurance contract's tax favored status beyond reasonable "public policy" bounds, or tortures compensation agreements and qualified plan structures into shapes that belie their intended morphology. Just as Congress "settled" certain issues surrounding annuities by declaring that the inside cash value accumulation was taxable to "non-natural" owners; it is not difficult to envision a similar legislative settlement of issues surrounding tax-motivated life insurance policies owned by trusts, corporations and other taxable "non-natural" persons. The collapse of the real estate tax-shelter industry under the

revised passive loss deduction regulations created a multitude of angry limited partners (despite the protestation of many vendors that the real estate lobby was far too strong to let such a thing happen). Recent proposals to reevaluate some of the basic tax characteristics of cash-value life insurance, in light of the phase out of estate taxes and a desire to lower tax rates while maintaining revenue neutrality are troublesome for buyers of tax-motivated life insurance.¹² This projected tax-law trajectory is a possible outcome of the historical patterns suggested by Belth. It forms the basis for the hypothesis that successful marketing of tax advantaged insurance programs sows the seeds of their own destruction. No prediction is implied; only a reminder that expected benefits should always be risk adjusted.

Legal Opinions and Trustee Prudence

Lawyers charged with providing legal opinions regarding insurance plans and fiduciaries charged with prudent management of life insurance assets both operate in a challenging and uncertain environment. An institutional trustee for an irrevocable life insurance trust may face significant liability exposure where the asset to be managed is a bundle of rights derived from a split dollar agreement (that governs the asset in a manner that parallels, in some respects, the trust instrument itself) between the trust and a sub-trust of a qualified retirement plan, wherein successful plan funding is a function of the presence or absence of promised tax benefits, or whether the IRS will overlook a policy rollout program dependent on "springing cash values". Both legal counsel and fiduciaries may want to request tax indemnification letters from vendors of tax-motivated insurance programs as a condition either of product purchase or retention.¹³ Additionally, trustees of ILITs and certain employee benefit programs should examine the degree to which the economic viability of assets under management depends on the persistence of current tax law or the viability of ongoing deductions and exemptions. Assets that are wrapped in tax-arbitrage plans such as split dollar agreements or that have poor economic viability absent certain future projected tax benefits may not be suitable investments for the trust portfolio.¹⁴

¹ The phrase "exciting and helpful" is taken from the conclusion of Richard Sheckman's article entitled "Retired Lives Reserve: The Product," *CLU Journal* (October, 1980), p. 26: "The leverage generated by these tax consequences, coupled with permanent death protection provided the insured, provides the estate and business planner with an exciting and helpful tool. Effectively, the RLR policy is providing the marketplace with a 'permanent term insurance policy.'"

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The insurance industry finds itself working through various competitive challenges from banks, mutual funds and other financial organizations, while, simultaneously, trying to manage credit and legal risks.

² Belth, Joseph M., "Legal Setbacks For Tax-Motivated COLI Plans," The Insurance Forum (March, 2002), pp. 21-30.

³ Milevsky, M. & Gottesman, A., Insurance Logic, (Stoddard Publishing) Toronto, 2002. p. 26.

⁴ Supra, p. 30.

⁵ The history of employer-sponsored group insurance draws on the following CLU Journal articles: Roberts, J.E., "Section 79—An Update," (April, 1975), pp. 8-14; Solomon, M. I. & Silberberg, P., "Group Permanent: Innovative Approaches for Business Insurance and Estate Planning," (July, 1975), pp. 34-44; Swirnoff, M.A. "The Effect Of The Section 2042 Final Regulations On Group Permanent and Split Dollar Insurance Arrangements," (July, 1975), pp. 50-58; Huthoefer, G. E., "Section 79 Group Ordinary Problems Still Remain," (April, 1976), pp. 10-18; Roberts, J.E. & Martin, R. T., "Section 79—The New Regulations," (October, 1979), pp. 24-33; Roberts, J.E., "Retired Lives Reserve," (January, 1978), pp. 31-37; and, Shechtman, R. G., "Retired Lives Reserve: The Product," (October, 1980)

⁶ Huthoefer, Supra p. 10

⁷ Roberts, J.E. Supra (1978), p. 34.

⁸ The insurance industry has been subject to widespread litigation for alleged deceptive practices in the marketing of insurance to individuals. Thousands of policies were sold as IRA or 401(k) alternatives under the marketing names of "individual pensions" or "private pension plans." See, for example, Richard Duhaime v. John Hancock Mutual Life Ins. Co., U.S. District Court for the District of Massachusetts, Civil Action No. 96-10706-GAO.

⁹ Jenkins, G.E., "Zero Pay Minimum Deposit Plans: The Interest Payment Question," CLU Journal (January, 1983), p. 60. For an interesting description of a modern life insurance marketing campaign suggesting that wealth can be transferred in a manner that avoids both gift and estate tax liabilities, see "IRS Loophole Allows Wealthy to Avoid Taxes" New York Times (Sunday July 28, 2002). The marketing campaign, although pitched to wealthy individuals, is based, in large measure, on a 1996 private letter ruling regarding the economics of split-dollar funding of life insurance policies.

¹⁰ One of the more creative marketing efforts in the 1970s was Wrap Annuities. The program promised owners of bank and S&L Certificates of Deposit that they could wrap their CDs in an annuity with the result that interest would no longer be reportable when credited. This program was short lived.

¹¹ Kehoe, D.M., "419A: A Legislative Odyssey," Journal of Financial Service Professionals (March, 2002), pp. 56-61; and McFadden, J. J., & Leimberg, S. R., "Welfare Benefit (Section 419A(f)(6)) Plans: What You Need to Know," Journal of Financial Service Professionals (November, 2000), pp. 72-79.

¹² Life Insurance Cash Value increases are currently subject to taxation if a corporation subject to AMT owns the policy.

¹³ This is a much different strategy for client counseling and liability mitigation than the parade of marketing gimmicks and "money-back guarantees" offered by certain insurance companies. See, for example, Leimberg S.R., & Gibbons, A.E., "Life Insurance: Decision-Making After September 11th and EGTRRA," Estate Planning (January, 2002), pp. 36-41.

¹⁴ On July 30th President Bush signed into law the Sarbanes-Oxley Act. The Act's prohibitions against corporate loans to executives or directors puts into question the ongoing viability of many corporate sponsored split-dollar life insurance programs. Insurance agents often recommend a transfer of employee rights in policies financed under split-dollar plans to irrevocable life insurance trusts.

MORE BAD NEWS FOR INSURERS

Sarbanes-Oxley Act

On July 30th, President Bush signed the Sarbanes-Oxley Act of 2002 into law. The Act initiates a series of reforms in public corporations and accounting firms. One provision prohibits companies from extending credit in the form of personal loans to executives or directors. Thus, it appears unlikely that certain traditional compensation devices such as housing loans, loans for stock option exercise, and loans for the purchase of life insurance coverage ("split-dollar" life insurance financing) will continue. Insurance carriers providing products to the "institutional" (i.e. corporate, trust and estate marketplaces) may experience a substantial decline in future premium revenues because of the ex-ante impact of the regulation on their anticipated cash flows, on their projected lapse ratios, or both.

Litigation by Corporate Clients

Unfortunately, several large life insurance carriers must absorb the exogenous regulatory shock of Sarbanes-Oxley in conjunction with the expenses and potential liabilities of litigation flowing from their corporate clients. For example, on September 9th, Wal-Mart sued AIG Life and Hartford Life for more than \$150 million. The suit alleges that the defendants did not fully inform Wal-Mart of tax-related risks associated with ownership of corporate owned life insurance programs. This case, as well as other suits brought by corporate plaintiffs against vendors of corporate owned life insurance (COLI) plans is attracting great interest from industry analysts. More than half of the Fortune 500 firms have implemented COLI plans and there may be over \$6 billion in tax benefits at stake. The US Third Circuit Court of Appeals, on August 21st disallowed the tax benefits claimed by Camelot Music, Inc., and ruled that the deductions were "shams in fact" [CM Holdings Inc, 3d Cir., No. 00-3875].

The insurance industry finds itself working through various competitive challenges from banks, mutual funds and other financial organizations, while, simultaneously, trying to manage credit and legal risks. Waves of merger and acquisitions have swept the industry over the last several years, and observers note that the industry has morphed into something very different than what existed even as late as 1990. Trustees that remain embedded in the trap of trying to find the insurance company that "offers the best deal," run the risk of surcharge for breach of the duty to diversify the portfolio. It is a very difficult time to manage insurance assets.

INDUSTRY HIT BY FINANCIAL, LEGAL SHOCKWAVES

To gain a better perspective, the \$23.4 billion exposure exceeds the statutory net income for the entire life insurance industry, which was \$10 billion in 2001.

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Scope of Exposure to Bond Losses

Based on data published in insurers' annual statutory statements as of December 31, 2001, Moody's estimates total industry exposure of \$23.4 billion to bonds issued by these companies. Additional exposure to problem fixed income securities may exist in the form of collateralized debt obligation pools as well as in the form of smaller holdings of such troubled firms as Calpine, Vivendi, Corning, etc. Estimated losses range from 25% to 50% of the money invested in the securities of the 10 troubled firms, although actual losses for any carrier cannot be known with certainty because risk-hedging strategies (i.e. interest rate swaps and derivative security management) are proprietary information.

Exposure Double Industry's Net Income

To gain a better perspective, the \$23.4 billion exposure exceeds the statutory net income for the entire life insurance industry, which was \$10 billion in 2001. The following life insurance companies have exposure to these troubled securities equal to or greater than 20% of their capital and surplus:

- ◆ AIG Life Insurance
- ◆ Allianz Life
- ◆ American General
- ◆ AmerUs Life
- ◆ Consec Life
- ◆ Fidelity & Guar. Life
- ◆ First Allmerica
- ◆ GE Capital Life of NY
- ◆ Horace Mann Life
- ◆ Jackson National Life
- ◆ JC Penny Life
- ◆ Life Ins. Co. of SW
- ◆ North American Co. for Life & Health
- ◆ Old Line Life
- ◆ Presidential Life
- ◆ SAFECO Life
- ◆ Transamerica Life
- ◆ USAA Life
- ◆ Western Southern Life
- ◆ William Penn Life NY

Which Insurers Face Greatest Exposure?

On average, the industry exposure to problem bonds issued by these 10 companies equals 7.2% of their end of 2001 capital. In terms of absolute dollar exposure (as opposed to exposure as a percentage of capital) the largest holdings are found in the portfolios of the following insurance groups:

- ◆ AIG Life
- ◆ Metropolitan Life
- ◆ New York Life
- ◆ TIAA
- ◆ GEFA
- ◆ Aegon USA
- ◆ Prudential
- ◆ Northwestern Mutual
- ◆ John Hancock
- ◆ Travelers

Some Insurers May Be Hiding Losses

Further, the Moody's report contends that some companies are engaged in financial strategies designed to hide losses from investors and policyholders. Some insurers are selling profitable securities sooner than planned, to generate gains that offset other losses. These strategies are particularly troubling because, as the report notes: "By prematurely realizing these gains, the companies are essentially front-ending future profits. This income is needed to cover future product benefits and crediting rates and accelerating their reporting by realizing gains will cause lower reported investment income and earnings in the future." Opportunities for financial gamesmanship are great. For example, companies might want to inflate current financial performance, so product illustrations look better. Actuaries cannot approve projections unless the assumptions used reflect current experience. But carriers pursuing strategies that bolster current income to the detriment of future earnings (i.e., the companies in the worst situation) may produce illustrations that belie economic reality. ILIT trustees shopping for "the best deal", or attempting to monitor insurance assets through in force illustrations are faced with a particularly difficult task.

Big Companies Hit With Big Downgrades

Among the large companies receiving significant ratings downgrades from Fitch are:

- ◆ Mass Mutual
- ◆ New York Life
- ◆ Great-West Life
- ◆ Jackson National
- ◆ Manufacturers Life
- ◆ Pacific Life
- ◆ Connecticut General
- ◆ John Hancock
- ◆ Lincoln National
- ◆ Metropolitan Life
- ◆ Principal
- ◆ Equitable
- ◆ Prudential
- ◆ MONY

Sales are Slipping, Too

Other developments are also of great concern. In downgrading the overall industry, Moody's notes significant drops in variable life and annuity sales. They posit that low sales, combined with significant declines in asset-based fees will "continue to be a drag on companies' earnings." Policyholders in recently demutualized insurers may suffer disproportionately, as: "Stockholder demands for earnings growth and higher returns on equity are causing companies to redeploy capital, increase their use of debt, and return excess capital to shareholders through share repurchase programs – actions which tend to reduce the insurer's capital cushion, flexibility, and overall creditworthiness."