FEATURE:
INSURANCE

By **Jon B. Mendelsohn**

Rethinking Life Insurance Valuation For Seniors

New risk factors require updated methodologies

Life insurance has long been considered a hard to value asset. Practitioners and planners have dealt with a variety of definitions of fair market value (FMV), depending on the particular application that's being addressed. Historically, standard valuation practices come with their own set of challenges. Similar to other asset classes, this topic is evolving, and there are current valuation methodologies that provide an independent market-based value for life insurance that accurately conforms to the Internal Revenue Service definition of FMV. This level of precision can influence planning scenarios and open up new options when dealing with complicated life insurance decisions involving senior clients.

Outdated Valuation Rules

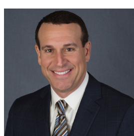
How do you determine the FMV of a life insurance policy? For decades, the sharpest minds have explored this topic. It's always been pretty straightforward for whole life and annual renewable term; however, there continues to be confusion and a lack of certainty regarding modern-day products. The usual default is to request a Form 712 from the carrier. The introduction of universal life (UL) and sophisticated term products in 1979 started a whole new wave of complex insurance products that are still evolving today. All of a sudden, interpolated terminal reserve (ITR) calculations provided on Form 712 were more complicated, and each carrier used its own formula, leading to inconsistent results. If your client purchased two identical UL products, on the same date, from two different carriers with the same face value and premium payments, it's highly probable that years later, the 712/ITR calculations would vary greatly from one carrier to another.[1] Here's the problem: If these values vary so much, then which one is accurate? In the eyes of the IRS, they both are.

The ITR, as a calculation of FMV, can be inconsistent and potentially unfavorable to your client. To make matters even more confusing, the carriers are reluctant to stand behind their calculations because of legal concerns. Many practitioners believe the IRS rules are outdated for modern-day life insurance products, but so far, no new regulations have been issued. In the meantime, there are situations in which clients are receiving unrealistic values for planning purposes or paying taxes on questionable calculations of FMV. This situation not only hurts clients, but also creates liability and exposure for planners and fiduciaries if other valuation methodologies aren't explored.

Practice tip: Planners should never order a formal Form 712 without first requesting an estimated value and understanding the implications. Once the Form 712 is produced, its value is considered irrevocable.[2]

Alternative Valuation of FMV

In situations in which there are only suggested guidelines and no definitive rule for determining FMV, many practitioners are asking for a more logical and defensible assessment. The IRS defines FMV as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[3] Historically, the most substantial impediment for determining FMV for life insurance has been the lack of existence of a formal and transparent secondary market to determine the value of a life insurance policy based on willing buyer/willing seller principles. This structure does exist today and



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provides reliable transaction data in a regulated and robust institutional global market with high levels of medical underwriting and sophisticated product intelligence to pinpoint FMV.

When it comes to the calculation of FMV for life insurance, all of the calculations provided by the insurance carrier are health agnostic and therefore general in nature and not specific to an individual insured. One of the most important elements that institutional investors review is the insured's current health condition. The current health of the insured is like a two-sided coin and can benefit your clients in two ways: (1) If the insured currently has significant health issues, the FMV increases proportionately with the seriousness of the health conditions. This increase in present value offers a potential exit strategy and liquidity event by monetizing the policy to help solve planning needs today; and (2) On the flip side, if the insured currently has standard or preferred health, most likely the present value of the policy will be no greater than the cash surrender value (CSV), which can be helpful for tax planning. For example: In a scenario involving gift transfer tax, the policy being transferred was an $8 million second-to-die UL with a CSV of $346,000 and premiums paid of $1.9 million. Due to the nature of the policy, the client's attorney ordered an informal 712/ITR value from the insurance carrier. That informal 712/ITR value was $2.6 million. Both insureds (male age 72 and female age 69) were in excellent health, and the market-based FMV was no greater than the CSV of $346,000. The market-based valuation was then used to help justify a more "common sense" value to choose. In this particular case, the attorney selected the premiums paid, $1.9 million, as a reasonable transfer value "considering all of the relevant facts."[4]

In situations in which FMV rules for planning aren't clearly defined, should practitioners request all possible values for a policy before deciding what value to use for reporting the transaction? In certain situations, "consideration should be given to obtaining an appraisal to determine a policy's fair market value, based on a willing buyer/willing seller analysis."[5] It isn't uncommon to see a healthy insured, age 60 to 75, receive a market-based FMV calculation that's significantly lower than an arbitrary 712/ITR valuation from the carrier. Therefore, even though the policy may have little to no value in the life settlement market, an FMV appraisal might be advantageous in other planning situations. As a result, a market-based secondary market valuation (SMV) was developed using real-time health and market data to arrive at a more precise appraisal of FMV.

Why would this logical approach be any different for insurance planning as it relates to other assets that a client owns? Can you imagine appraising or valuing real estate for a dollar amount without taking into account the actual location, market trends, availability of buyers and other relevant factors? That's exactly what's been happening for decades in many instances regarding insurance valuation.

> Market-based valuation methods result in a valuable time-stamped, mark-to-market appraisal that provides more certainty for complicated planning scenarios.

Market-Based Valuation

A few years after the credit crisis had abated, a repositioning and growth sector of the secondary market emerged that focused on life insurance that matched willing buyers and willing sellers. The result is a regulated and transparent institutional life settlement market. It allows for policy owners to sell their life insurance policy for a lump sum that's more than the cash value and less than the death benefit. Many of the most capitalized institutional funds, private equity and pension plans went through the appropriate licensing requirements and became willing buyers in this re-energized secondary market. The willing sellers are individuals, corporations, trusts, charities and others that purchased life insurance at one point in time. Their needs have changed, so they're looking for exit strategies for their

life insurance. This is a legal right to explore under the insurance contract that they purchased, essentially a property rights issue. With this knowledge and available data point, fiduciaries began to dig deeper into this valuation issue, and requests for more reliable FMV methodologies became more common. Initially, many of the requests were from attorneys as a result of unrealistic 712/ITR values or confusion about how to accurately solve this issue. The scope of the valuation requests became more comprehensive as sophisticated attorneys, insurance professionals, CPAs and trustees confronted new life insurance planning challenges with senior clients. It became clear that it was time for a more defensible appraisal of FMV.

It's estimated that 20 percent of seniors who surrender policies are potentially leaving six to seven figures of additional value on the table.

It wasn't until the past decade that a fully regulated and transparent institutional market for life insurance became a reality. Data provided by the life settlement market enables market-based valuations to factor in the all-important issue of the current health of the insured. Carrier estimates of FMV are health agnostic. Standard alternative life insurance appraisals are also health agnostic and rely on historical data from previous life settlement transactions and alternative investments to determine an appropriate discount rate. Standard mortality tables, used by the insurance industry, are then applied to estimate life expectancy based on age only and giving no consideration to the actual health of the insured.

The new market-based SMV methodology differs from standard appraisal methods and carrier estimates of FMV in five ways:

1) It's based on a full set of objective transactional data and comparables from current institutional buyers that represents a true willing buyer/willing seller environment.
2) It provides a longevity data point useful for tax planning and hold/pay/change/sell decisions for senior clients.
3) It includes an in-depth analysis of the current health conditions of the insured to determine life expectancy. No medical exam or paramedical exam is required. Medical records for the past five years are examined, and a series of credits and debits are applied based on medical conditions, activity level and family history. Independent third-party life expectancy reports are obtained to provide further definition to mortality assumptions.
4) The appropriate discount rate is derived from cash flow analysis of current life settlement market transactions (not historical transactions) for real-time comparable data.
5) The policy type, policy values, current premiums, features, carrier rating and the portfolio needs of the institutional buyers as they are at the time of the valuation provide additional considerations for debits and credits and the resulting discount rate.

Market-based valuation methods result in a valuable time-stamped, mark-to-market appraisal that provides more certainty for complicated planning scenarios. It gives attorneys and planners a more defensible appraisal of FMV to use as an additional longevity and financial data point when making decisions about which value to select for FMV.

To understand the significance of the market-based valuation, you only need to look at other valuation processes like real estate appraisals, business valuations and appraisals of jewelry, fine art and automobiles. All of these appraisals rely on comparable data from the current market transactions based on similar property features, marketability, special considerations and physical condition of the property being appraised. A system of credits and debits is applied based on the specific property being valued. If the secondary market for these assets is strong, the FMV is greater. Likewise, if the current market is weak, the FMV decreases proportionately.

Market-based appraisals of life insurance are very granular in nature and designed to reflect the parameters of institutional investors that have become much more sophisticated in their medical underwriting, longevity data and policy analysis. The process is Health

Insurance Portability and Accountability Act compliant and abides by all privacy and confidentiality requirements. A key component is the ability to access current comps and identify the daily shifts in purchase parameters that reflect the willing buyers.

This is where the rubber meets the road with the market-based valuations because of access to real-time market conditions and comparable data to help drill down and find the true FMV. This type of additional market exploration achieves a level of precision that provides a solid foundation when needed for tax planning or hold/pay/change/sell decisions that are becoming more frequent for senior clients.

Longevity Risk and Wealth

There's been an uptick of valuation requests for senior clients in their 80s and 90s. Many seniors are living longer than expected and experiencing significant premium increases if they want their policies to last until the maturity date. This wasn't meant to happen, but it is. It's a result of a combination of factors that have progressed over the last 35 to 40 years. The introduction of UL and sophisticated term products gave clients and planners more flexibility and required more management. With the passage of time, many of the advisors involved in the issuance and management of the policy have since died or retired and left some seniors without an advisor who's managing the policy. The sustained low interest rate environment also has severely impacted policy performance. The result is many seniors with unmanaged, poorly performing policies in danger of lapsing due to insufficient premium payments. Unfortunately, too many of these clients are surrendering their policies (forfeiting polices back to the carrier) without ever getting the policy appraised for FMV. It's estimated that 20 percent of seniors who surrender policies are potentially leaving six to seven figures of additional value on the table. Those seniors who could benefit from a market-based valuation miss that opportunity because they're not represented by an advisor, or often times, the advisors they trust to help them make wise decisions are unaware of the opportunity to uncover additional value.

To make matters even worse, the ever-increasing life expectancy due to medical advancements and the healthy lifestyles of wealthy seniors has placed even more policies in jeopardy. It's not uncommon to hear that many of these clients are still working, exercising, traveling and remaining vigorous, well into their 80s. This creates a predicament for seniors whose financial advisor originally planned for their life insurance to last until age 82 and then find themselves healthy at age 79 and projected to live into their earlier 90s. This longevity surprise can be both a gift and an area of concern as they search for ways to fund their independence.

Unfortunately, when it comes to life insurance, seniors might be forced to pay significantly increased premium payments on in-force policies to maintain the policy benefit. That increase in premium payments may not be the appropriate path to follow for a life insurance policy that may no longer be needed or may not be the best use of financial resources for estate and retirement planning. A market-based valuation can be a valuable planning tool that helps clarify hold/pay/change/sell decisions at this point. Market-based valuations determine the crossover point at which continuing to pay premiums may no longer be favorable to selling the policy. The American Taxpayer Relief Act of 2012 increase in the estate tax exemption has also caused many senior clients to question the feasibility of maintaining all of their life insurance that was purchased for estate protection. If the senior insured has any relevant health conditions, a market-based valuation could help expose the opportunity for a full or partial sale of the policy to meet current needs.

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No Surprises

Most wealthy clients have more than one life insurance policy. One of the reasons they have several policies versus just one large policy is to make sure there's diversification between carriers and product types. This helps them smooth out the bumps created by unpredictable events and therefore causes less uncertainty for their beneficiaries. I recently had an attorney contact me

about his client who was living much longer than anyone had ever predicted, an 87-year-old surviving matriarch, who was the insured on several policies held in trusts. The policies were becoming expensive to maintain, and the attorney wanted to know if I could determine the present value for each policy and explain the necessary premium requirements in a variety of life expectancy scenarios so the planning team could determine if they should recommend policy restructure or other available options. Their desired outcome was to provide more certainty in the client's financial and long-term care needs. The family was uncomfortable with the annual conversation of "to fund or not to fund" based on their loved one's projected life expectancy. The attorney wanted to know the breakeven point (crossover point) at which, if the client continued to live, it would make more sense to sell one or more policies than to keep paying premiums. An analysis showed the crossover points for each of the five policies. One of the policies had a crossover point at age 93, and, based on medical underwriting, it was quite likely that the client could live well into her late 90s. The attorney now had conclusive evidence to support a recommendation of selling that policy prior to age 93 if the insured was still living. The proceeds of the sale could then be used to fund the remaining policies. In this manner, the attorney was able to demonstrate how to maximize the results for the family and eliminate surprises and liability.

New Concerns for ILIT Trustees

The management of life insurance policies is a daunting task for both professional and accommodation trustees (a family member or friend). Accommodation trustees rarely have the expertise to review and understand complex life insurance polices. Often, the only duty they perform consistently is sending out *Crummey* notices. On the other hand, professional trustees were made well aware of the risks involved in managing trust-owned policies when the Uniform Prudent Investor Act (UPIA) was implemented in most states in the 1990s. The UPIA requires all trustees to manage assets held in the trust as a prudent investor would. It further implies that life insurance is one such asset to be managed.[6] Some trustees manage hundreds of irrevocable life insurance trusts (ILITs), which usually contain UL policies. After the introduction of UPIA, most states passed legislation that allows trustees to delegate the responsibility of policy management to a third party. As a result, a new cottage industry of policy review firms popped up overnight to meet this need. Unfortunately, few if any of these firms include an analysis of FMV in their policy review process. Trustees are often faced with a decision about whether to increase premiums on a policy that's becoming expensive to maintain or to surrender the policy before the cash value depletes any further. It's common for UL policies held in ILITs to underperform and run out of cash value because of the sustained low interest rate environment of the past several years. Many policies that were issued in the 1980s and 1990s were projected to have a double-digit internal rate of return instead of the low single-digit returns that they actually experienced. I've spoken with ILIT trustees in the past who broke out in a cold sweat because they'd recently surrendered a policy for cash value that would have been worth hundreds of thousands of dollars more if they'd valued and sold it in the secondary market. Could there be liability for not exploring this option? Would a fiduciary deliberately not disclose other non-forfeiture options, such as reducing the face amount, surrendering the policy or completing an IRC Section 1035 exchange? The addition of a market-based valuation as part of the policy review process mitigates risk for the trustee and helps serve the best interest of the trust.

COI Risk

The increasing longevity of seniors, combined with the sustained low interest rate environment, has prompted several insurance carriers to substantially increase cost of insurance (COI) charges and premium payments on in-force policies. Litigation is ongoing, and some carriers have raised premiums by triple digits.[7] This new risk factor has massive implications for policy owners, fiduciaries and trustees. If your client hasn't already received a premium increase notice, there may still be one coming. An independent policy valuation can help to determine the impact on your client's individual planning situation. What could be the consequences of ignoring these increases in premium expense? Many policy owners have to make immediate decisions about how to manage their life insurance. They might have been under the impression that they wouldn't have to pay premiums for another eight to 10 years, and now they're faced with premiums due in the next one to three years. Do they have the available liquidity? Could other

areas of their plan suffer? Will they be forced to minimize their philanthropic planning goals? It's difficult to make a prudent decision on what to do without first determining the value of the policy and the availability of future premium reserves. What's the liability of fiduciaries that don't complete due diligence to help manage the life insurance assets of their clients?

This same concern of COI changes also applies to other estate and business planning areas in which clients own life insurance: buy/sell, key executive, business valuations, mergers and acquisitions, bankruptcy, charitable planning and long-term care. Proactively paying attention to this risk factor can prevent clients from allocating liquidity for policies that no longer suit their needs or are underperforming based on original expectations.

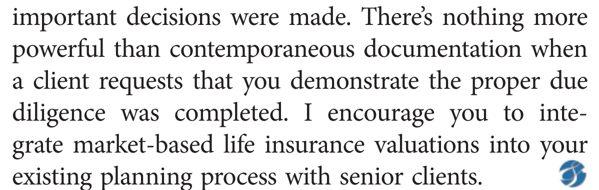
On a positive note, many of the institutional funds in the secondary market have a large portfolio of policies and can absorb policies with increased COI into their existing pools. The outcome of a valuation might determine that there could be an exit strategy for policy owners that results in a substantial liquidity event by selling the policy as a life settlement.

Representation

Similar to any transaction with willing buyers and willing sellers, there are representatives that advocate for each side. It's critical to obtain an FMV appraisal from an independent licensed company that's aligned with you because it has a fiduciary duty to your client and no affiliation with buyers or buyer representatives. Full and total transparency should be the standard deliverable with all applicable reps and warranties that the information is representative of FMV in the regulated life settlement and secondary markets for life insurance.

Market-Based Valuations

If you need accuracy for longevity planning, tax planning, business planning or complicated life insurance decisions, market-based valuations provide a solid foundation to help you discuss options with your clients that help assure that their best interests are being served. Determination of SMV, for policies of retirement age clients, also helps mitigate risk for planners and fiduciaries who could find themselves questioned at a later date by policy owners or beneficiaries about whether the proper valuation was determined at the time when



important decisions were made. There's nothing more powerful than contemporaneous documentation when a client requests that you demonstrate the proper due diligence was completed. I encourage you to integrate market-based life insurance valuations into your existing planning process with senior clients.

Endnotes

1. Keith Buck and Stephan R. Leimberg, "Life Insurance Valuation: What Advisors Need to Know," *LISI Estate Planning Newsletter #1638* (May 10, 2010), *leimbergservices.com.*
2. Michael F. Amoia, Robert C. Slane and Jon B. Mendelsohn, "Complexities of Life Insurance Policy Valuation," *Estate Planning Magazine* (June 2014).
3. Treasury Regulations Sections 20.2031-1 and 25.2512-1; Revenue Ruling 59-60.
4. Amoia, *supra* note 2.
5. Lawrence Brody, "The Top 25 Insurance Planning Mistakes," The Dallas Estate Planning Council Meeting (May 5, 2016).
6. "Prudent Investor Act Summary," Uniform Law Commission, The National Conference of Commissioners on Uniform State Laws.
7. Leslie Scism, "Life Insurance Customers Push Back Over Surprise Cost Increases," *The Wall Street Journal* (Sept. 1, 2016).

SPOT LIGHT

Lost in Thought

"Adolescent (Close Up)," by Roy Decarava, sold for $1,430 at Swann Auction Galleries' African-American Fine Art sale in New York City on Oct. 6, 2016. Decarava, who began his artistic career as a painter, is also a renowned photographer. He documented life in Harlem through subjects who included both prominent figures and his next-door neighbors.