

LEIMBERG'S THINK ABOUT IT

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A GUIDE TO THE AGENT FACED WITH SERIOUSLY ILL CLIENT:

One of your clients is ill, perhaps very ill. He or she may have only months to live.

It is your responsibility to review his or her life insurance coverage and make appropriate recommendations to him/her, as well as to his/her advisors (e.g., CPA and attorney).

Where do you start? How do you proceed?

STEP 1: OBTAIN ALL LIFE INSURANCE POLICIES ON CLIENT'S LIFE.

Begin the process by collecting all the policies the client owns on his/her own life, all single-life policies on the client, as well as survivorship policies on the client and spouse, owned by trusts, partnerships, LLCs, corporations, adult owner-beneficiaries, charities, and third party owners. Obtain copies of governmental, fraternal, group, and association insurance documents as well as individual coverage.

- Immediately contact the home offices of the insurers to confirm, in writing, the current
 1. ownership,
 2. beneficiary(ies),
 3. loan and lien information, and
 4. payment status:
 - * Is the coverage in danger of lapsing?
 - * To what date are premiums paid?
 - * Has the policy already been placed on reduced paid-up or extended term insurance status?
 - * Are cash values or other policy values being used to keep the policy in force?
 - * To what address is (are) premium notice(s) and other policy information being sent?
 - * Should duplicate premium notices be requested?

- Copy and safeguard copies or verification (e.g., checks or bank statements) of the last three years of premium payments.
- Assemble and check all brochures and other marketing/sales literature that accompanied the insurance proposals or policies. Ascertain if the actual results conform, to a reasonable degree, to what was promised or projected. If there is a drastic difference between projections and actual performance (based on type of policy and consequent risks accepted by policyholder), consider appropriate action.
- Decide if the changes in your client's health and/or other changes since the policies were purchased warrant reassessment of the amounts and types of coverage.
- Consolidate and safeguard originals of all policies and related documents.
- Check to see if any of the policies provide for an accelerated (viatical) payment by the insurer. If so, would the favorable tax consequences and immediate cash payment offset (or override) the disadvantages of holding the policy until the insured's death? If the client's life expectancy is relatively short, in most cases the coverage should be continued in force rather than surrendered or sold to a life settlement company.

But no course of action – or inaction – should be assumed. Each policy or certificate of insurance should be considered both independently and as part of the overall analysis of the client's circumstances and objectives.

- Consult with client's counsel to determine if any individual coverage the client currently owns could (and should) be removed from his/her estate by an absolute assignment, and assess the risks and benefits should the client die within three years. If an absolute assignment of ownership were made, the donee-recipient should immediately begin to pay all premiums with funds not borrowed from the client.
- Consider with client's counsel if any group term coverage on client's life could (and should) be removed from his estate. It is essential that the master contract permits such absolute assignment.

STEP 2: OBTAIN ALL POLICIES AND COVERAGE OWNED BY CLIENT ON OTHERS' LIVES.

It is often the case that a client owns life insurance on his/her spouse, child(ren), business associate(s), or debtor(s). Each confirmation and analysis you make in Step 1 above should be made with respect to insurance owned by your client on the life (or lives) of other(s).

- Consider contingent ownership arrangements so that at the client's death, the ownership of the policy on the life of another will pass, not under the client's will, but rather automatically by contract provision to the contingent owner. This avoids: the delay and uncertainty of probate, subjecting the policy to a will contest, making the policy cash value available to the client's creditors, and in many cases subjecting the proceeds to federal estate tax.

For instance, if a client owns a policy on her husband's life and she predeceases him, absent a contingent owner (e.g. an adult child or trust), it's likely that the policy will pass through her will (and probate estate) back to the insured, thus potentially exposing it to federal estate tax at his death (unless he gifts the policy to a third party and lives three years after the transfer).

- Check to see if the client has a community property interest in a policy on him/her owned by his/her spouse that will cause a portion of the proceeds to be included in his/her estate.

STEP 3: VERIFY THE CLIENT'S CURRENT LEGAL CAPACITY TO CONTRACT.

Ascertain if the client is currently legally, mentally, physically, and emotionally able to make changes in any of the life insurance on his/her life or that he/she owns on others' lives. Also consider how soon that capacity to make changes might deteriorate or cease entirely, and the implications of these possibilities.

- Find out if anyone other than the client has the legal capacity (e.g. through a power of attorney, or as trustee, custodian, conservator, corporate officer, or joint owner) to make changes in the life insurance contracts on the client's life, or that the client owns on the life (or lives) of other(s).
- Should one or more parties have the capacity to act on the client's behalf as his/her agent to make changes in the life insurance on his/her life, ascertain if such a power will be considered an incident of ownership held by the client in the insurance on the client's life – and thus cause estate tax inclusion.

STEP 4: ASCERTAIN THE CLIENT'S ABILITY TO OBTAIN ADDITIONAL LIFE INSURANCE IN SPITE OF HIS/HER PRESENT CONDITION.

- Can additional insurance be obtained through offers by, credit card companies, charge accounts, installment loan agreements, mortgages, conditional sales contracts, employment groups, professional associations, or other financial institutions or arrangements?
- Can additional insurance be obtained through memberships in groups (such as AARP) which, through arrangements with commercial insurers, makes life insurance available without medical underwriting (but under restrictive terms).
- Ascertain the availability, viability, and utility of options such as paid-up additional insurance, or extended term insurance in the client's existing policies where these are offered (e.g., by changing the dividend option).
- If the client is still working, is additional coverage – even in relatively small amounts – available through group or pension “guaranteed issue” coverage? If so, what are the restrictions/limitations?
- Check all policies on the client's life to determine if there are any term riders which can be converted to permanent coverage before the riders expire.
- Check all policies on the client's life for any guaranteed insurability riders which enable the purchase of additional insurance at specified ages (and/or triggering events) regardless of the insured's health when the option is exercised.
- Check “substandard insurers,” or carriers that specialize in underwriting various impaired risks, to determine if they will issue insurance under the client's circumstances.
- Check all recently lapsed policies to see if there are any extenuating circumstances under which they can be reinstated without evidence of insurability. Is the lapse of coverage due to insurer's administrative error, for example, if “late notice” of premium due was not sent to the insured in a timely manner or to the correct address?
- Place policies that the insured can no longer afford on extended term rather than reduced paid-up (after checking to be sure the term will significantly exceed the client's likely life expectancy).

STEP 5: ASCERTAIN IF ANY OR ALL OF THE POLICY(IES) ARE SUBJECT TO COMMUNITY PROPERTY LAWS.

If the client currently resides in (or during the time the insurance was in force lived in) a community property state, the cash values and/or the proceeds may be considered community property. This characterization will have important (and potentially adverse) tax, dispositive, and creditor implications. So it is necessary to check each policy you've uncovered in Steps 1 and 2 and ascertain the ramifications.

For instance, to the extent someone other than the client's spouse receives the proceeds of a policy on the client's life and the premiums were paid with community funds (deemed half client's and half spouse's), the surviving spouse will be treated as making a gift of a portion of the proceeds (generated by her share of the premium payments) to the named 3rd party beneficiary.

STEP 6: CHECK CURRENT BENEFICIARY DESIGNATIONS AND DISPOSITION/PAYMENT OF PROCEEDS.

Ascertain if the beneficiary designations are up to date and in conformity with the client's intentions.

- Confirm with the client each beneficiary designation as to their name, relationship, and the amount or percentage of the proceeds each is entitled.
- Check to be sure each designation follows the "Rule of Two," i.e., there are at least two back-up or contingent beneficiaries for each party named. This is particularly important if the client's beneficiaries are elderly and/or infirm, or very young. Also, consider a charity as the ultimate contingent, "fail safe" beneficiary.
- Consider in every case if outright payment of proceeds is appropriate – or if the payment should be in trust, or in the form of a settlement option with certain guarantees and/or restrictions.
- Where there are multiple beneficiaries involved or where one or more are minors or incompetent (because of mental, emotion, physical, or other condition), or if the size of the policy warrants, a trust should always be considered.
- The use of a settlement option may be suitable where the amount in question is small but comprise a relatively large portion of the recipient's financial security. On the other hand, a trust is indicated if investment flexibility and safeguards against inflation are more important than (or outweigh) the inherent advantages of the simplicity, safety, cost efficiency, and dependability provided by a settlement option.

- If a beneficiary change is appropriate and requested, the safest course of action is typically to obtain the insurer's change of beneficiary forms. However, if time is of the essence and/or the insurer does not respond quickly, consult with the client's counsel. Note that any attempt to change a life insurance beneficiary through a client's will is likely to be ineffective and may lead to both disappointment and litigation.
- If all or a portion of any policy is payable to a charity, confirm that the charity is still in existence, that there will be no confusion as to exactly which branch of the charitable organization will receive the proceeds. For example, the designation should read: Boy Scouts of America, Troop 74, North Wildwood, New Jersey, rather than The Boy Scouts – assuming the client wants the proceeds to benefit the local Boy Scout troop rather than the national organization.
- Confirm that the intended recipient of policy proceeds is still alive. If the intended beneficiary is extremely ill or elderly, determine whether or not the proceeds should be paid in trust for his/her lifetime and then to a remainder-person or directly to someone else. Is the beneficiary in the process of a divorce or separation, or is currently or about to become bankrupt, or is likely to lose a large litigation suit. Determine who should be named otherwise.
- If any of the named beneficiaries are not the insured's natural or legally adopted children (e.g. step or foster children), check with counsel to assure there is no conflict with applicable state inheritance law. Likewise, if such children were not intended to participate in a share of the policy proceeds, check with counsel as to whether or not state law will automatically award them such rights if the policy beneficiary designation provides a distribution to "all my children, in equal shares."
- If the named beneficiary is the insured's spouse and he/she is not currently a U.S. citizen, check with counsel with respect to the need for, or appropriateness of, a Qualified Domestic Trust (QDOT), or for the spouse to become a U.S. citizen as quickly as possible.

STEP 7: ASSEMBLE AND SAFEGUARD PROOF OF AGE AND OTHER IDENTIFICATION DOCUMENTS.

- Obtain and safeguard copies of the client's birth certificate and/or Social Security information to prove that the client's age has been correctly stated on the insurance application(s). Check and verify the information as shown on the actual policy "declaration" page(s).
- Obtain and verify the address, social security number, phone number(s) and e-mail address for each party named as a beneficiary.
- Confirm they are all living and ascertain if any special circumstances (such as age, legal, mental, or physical disability, emotional instability) would prevent them from properly handling the policy proceeds.

STEP 8: OBTAIN/REVIEW COPIES OF ANY DOCUMENTS, (SIDE) AGREEMENTS, AND COLLATERAL ASSIGNMENTS IN CONNECTION WITH LIFE INSURANCE ON THE CLIENT (AND SPOUSE).

- Review all loan documents with, and collateral assignments of policies (on the client's life, or the lives of client and spouse) to, banks or other financial, lending institutions, in connection with business or personal loans, lines of credit, et cetera.
- Review loan documents and collateral assignments pertaining to premium financing arrangements (3rd party and/or private).
- Request copies of any split-dollar agreement and related assignment; documents for executive bonus arrangement; nonqualified deferred compensation agreement; buy-sell agreements (e.g., for section 303, or entity, or cross purchase or "wait-and-see" arrangements).
- Request copies of any pre- and post-nuptial or marital settlement agreements or divorce decrees that impact on the life insurance. Check to see the terms of those agreements and assure their conditions can and will be met.

STEP 9: CHECK BENEFICIARY DESIGNATIONS OF POLICIES ON OTHERS' LIVES OWNED BY CLIENT.

Be sure that if the client owns a policy on another person's life that the beneficiary is not a third party.

STEP 10: CHECK EACH BENEFICIARY DESIGNATION TO ASSURE THAT NO PROCEEDS ARE PAYABLE TO THE INSURED CLIENT'S ESTATE.

A relatively modest sized policy payable to the estate in the amount of known and admitted debts and expenses may be appropriate in some smaller estates.

In most cases, however, it is best to have the proceeds payable to a named beneficiary in order to avoid automatic and generally unnecessary federal and state death tax inclusion, thereby subjecting the proceeds to the claims of the insured's creditors, or risking the delays, uncertainties, as well as incurring fees and expenses of probate, or making the proceeds part of the amount a surviving spouse can elect against, or similarly subjecting the proceeds to a potential will contest.

STEP 11: CHECK THE SOLVENCY AND FINANCIAL CONDITION OF EACH INSURER.

Make sure the insurers that issued the policies are solvent and financially stable. If necessary, take appropriate and immediate action in the unlikely event that one or more are financially imperiled. (When was the last time this was checked?)

STEP 12: CHECK ANY TRANSFERS OF POLICY OWNERSHIP AND EXAMINE THE IMPLICATIONS.

- Has the contestable period been met?
- Has the suicide period been met?
- Are there apparent potential insurable interest issues that might cause an insurer or the insured's estate to contest payment of the proceeds?
- Are there apparent substantial misrepresentation issues that might cause an insurer to either contest payment of the proceeds, or rescind the contract?
- Did the insured transfer the policy on his life within the last two or three years such that there may be a "transfer within 3 years of death" estate tax inclusion?

If so, the donees of such policies should be encouraged to pay premiums with their own personal funds so as to minimize the percentage of the proceeds that would be includable.

- Is there a transfer for value issue and, if so, can the transaction be brought into a safe harbor?

STEP 13: CHECK FOR WAIVER OF PREMIUM OR WAIVER PROVISION IN EACH OF THE POLICIES

Waiver of premium is not used to the same degree with policies issued recently as in the past. This is because of the popularity of the "no lapse guarantee" feature (available with many products sold currently) under which, if a specified premium is paid, the contract guarantees a death benefit regardless of the level of cash value, etc. With respect to these policies, there is less concern with "waiver" because the premium has to be paid as specified.

However, there are millions of policies in force with the waiver of premium provision intact. If your client has one or more such contracts:

- Determine if the policy contains the provision and if it is still operative.
- Assist the client in obtaining a refund of premiums paid during the "waiting period."
- Explain to the client the general implications of the provision, and confirm whether the premiums are waived (for whole life or fixed premium products), or, if only the monthly deductions and expense charges for insurance are waived (as in the case for flexible premium or adjustable life insurance policies).
- Make any other changes possible to assure that no policy unintentionally lapses.

STEP 14: CONSIDER THE PROS AND CONS OF CHANGING THE PREMIUM PAYMENT MODE.

- If insurer refunds post-death unearned premiums, consider switching to annual payment mode (which would reduce the possibility of an unintentional lapse).
- If insurer does not refund post-death unearned premiums, consider switching to quarterly or monthly mode. This may increase the potential that a policy may unintentionally lapse. However, almost all insurers accept payments (generally with a required minimum amount for each transaction) directly from premium payors' pre-authorized bank accounts according to a fixed schedule that can be on a monthly basis.

STEP 15: CONSIDER USING POLICY LOANS AS A MEANS TO DISCRETELY SHIFT WEALTH.

A decedent's will provisions become publicly available during probate, while transactions with respect to life insurance policies are almost always private. If privacy is important, consider paying off or paying down policy loans which can:

- Reduce the size of the probate estate and, by doing so, reduce fees and probate expenses, state taxes in states which imposed no death tax on life insurance proceeds, and minimize uncertainty.
- Speed up the flow of cash to intended recipients.
- Reduce the potential for problems typically associated with will contest, or statutory election against the terms of the will.
- Reduce the wealth passing to heirs of the client's will and increase the wealth passing to contractual recipients of the life insurance proceeds, i.e., named beneficiaries of the policy – which may result in a subtle yet highly effective dispositive change. This tactic can provide more (or less) of a marital deduction depending on the recipient of the policy proceeds.
- Increase the amount of proceeds available to be placed under a settlement option agreement (with the insurer) – which can be quite useful in cases where, in lieu of a lump sum, the proceeds are paid to the beneficiary(ies) over a certain period of time (or their lifetime). A settlement option is an efficient and cost effective alternative to a trust – if the latter is impractical or, for whatever reason, not wanted.

Similarly, borrowing against the policy cash values can:

- Provide the client with a source of liquidity to pay current bills, finance otherwise unaffordable medical care, and other ancillary expenses.

- Enable the client to maximize annual exclusion gifts, thus reducing the estate without utilizing his/her lifetime gift exemption.
- Enable the client to make currently deductible gifts to charity that would not only reduce current income (and therefore income tax) but also reduce the size of his/her taxable estate.

STEP 16: CHECK ALL POLICIES OWNED BY OTHERS ON THE CLIENT'S LIFE

- Check to see if the policy proceeds are payable to, or for the benefit of, the client's estate (which would cause the proceeds to be included in his/her estate).
- Affirm that a policy owned by another on the client's life is payable to the owner to avoid an inadvertent gift of the proceeds by the owner to the third party beneficiary. Or, in the case of a corporate owner, a potential dividend, or compensation.
- Check to see if the client has retained an incident of ownership that would cause a policy on his/her life owned by another party to be included in his/her estate.

STEP 17: CHECK ALL SURVIVORSHIP POLICIES OWNED BY THIRD PARTIES (PARTICULARLY IRREVOCABLE TRUSTS).

Survivorship or second-to-die policies should be included in the review process – especially when they are owned by irrevocable trusts. More often than not, the client and his/her spouse have been making gifts to the trust to enable the trustee to make premium payments. Or, a premium financing arrangement may be involved.

Are there any prior planning strategies considered so that, in the event one of the insured grantors should die, there would be a viable solution to handle the ongoing premium and related gifting issues? Are there premium financing problems that must be addressed?

Consult with the client's attorney and CPA to:

- Determine to what extent the client's and spouse's annual exclusion gifts are used for premiums on the policy(ies) in question. Are there any other gifts that may be re-directed?
- After the client's death, will the surviving insured spouse's gifts of premium still be sheltered by his or her available annual exclusion? If not, is there any remaining lifetime gift exemption that can be utilized? For how long?

- Similarly, if the gifts by client and his/her spouse are used to service the loan under a premium financing arrangement, how would the surviving insured spouse handle the ongoing gifts?
- Are there income-producing assets in the trust? Is the income being used for premium or interest payment on premium financing loans? Will the income support the ongoing cash flow?
- If the trust is "unfunded," determine if it would be feasible or viable for the client and spouse to transfer (gift) income-producing asset(s) to the trust, so that the income from the trust-owned asset(s) may be used for ongoing premiums, etc. This one-time gift could eliminate the need for, or reduce the amount of, the ongoing gift. (Note that any gift tax paid within three years of death would be includible in the deceased grantor's gross estate.)
- Alternatively, would a short-term GRAT (with the trust as the remainder beneficiary) be, for example, a viable solution to an outright gift of income-producing asset(s)?
- Could the client and spouse (and after the client dies, the spouse) afford to give up the income from the transferred asset(s)?

CONCLUSION:

The tasks and action steps are not, of course, a complete list of all the things an agent should do – nor must an agent do all the things listed. And the steps – and sub-steps – are not necessarily in the order in which they should be accomplished in every case. The 17 Steps are meant as a general guide to which each agent should make his or her own order of priorities, and add or omit tasks that are more or less relevant to the client's particular circumstances.

Coordination and cooperation with other members of the client's planning team is essential. Each member should uncover issues and attempt to share and solve problems according to professional skill strengths and the scope of the engagement with the client and the expectations of the client's other professionals.

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