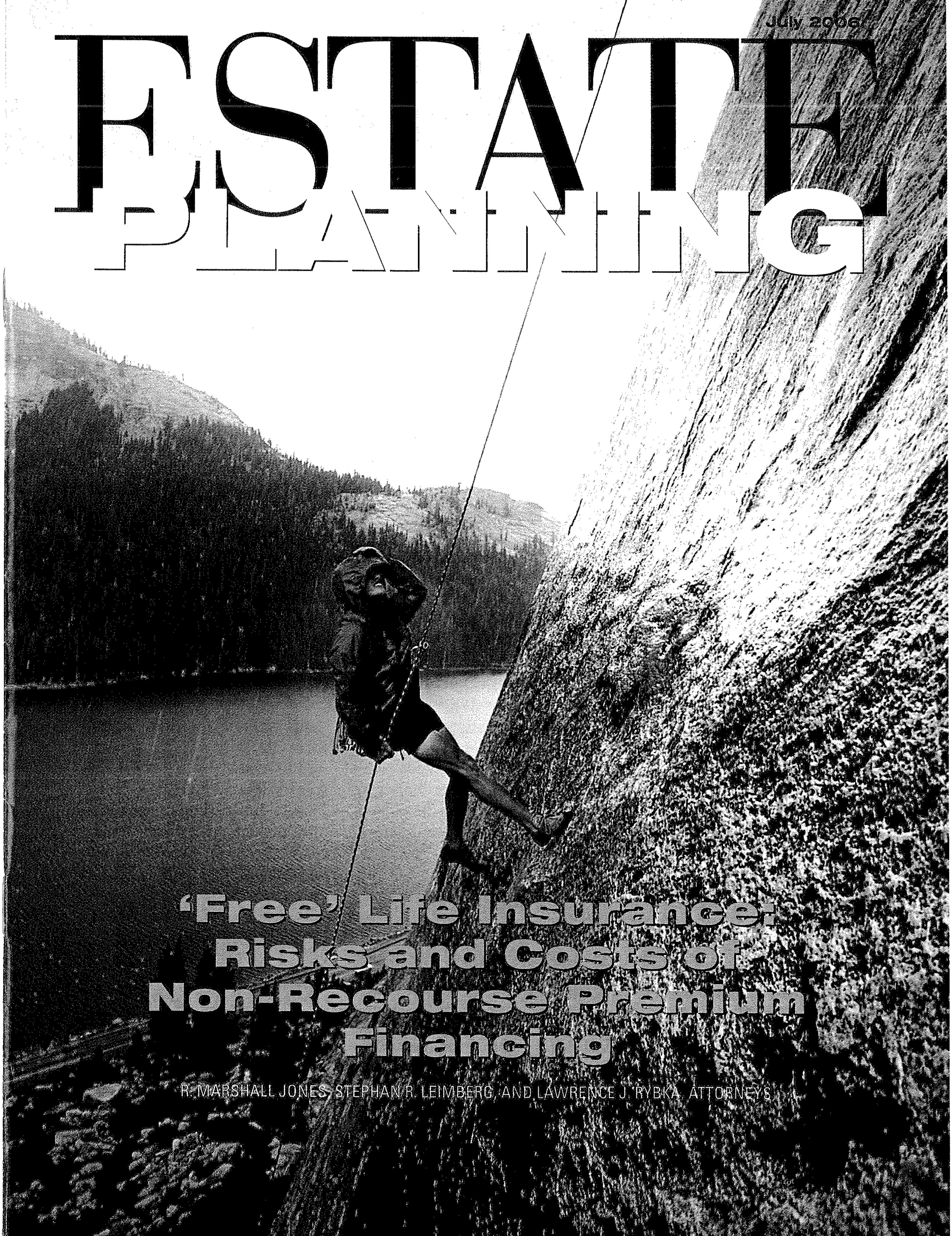
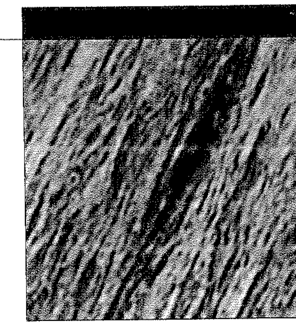
July 2006

ESTATE PLANNING



'Free' Life Insurance: Risks and Costs of Non-Recourse Premium Financing

R. MARSHALL JONES, STEPHAN R. LEIMBERG, AND LAWRENCE J. RYBKA, ATTORNEYS



'Free' Life Insurance: Risks and Costs of Non-Recourse Premium Financing

Non-recourse premium financing arrangements purport to offer insureds 'free' life insurance coverage for two years—but there are risks, including violations of state insurance laws, violations of securities laws, and uncertain tax costs.

R. MARSHALL JONES, STEPHAN R. LEIMBERG, AND LAWRENCE J. RYBKA, ATTORNEYS

Recently, a number of promoters have been offering a new life insurance scheme that promises "free" insurance for two years through various non-recourse premium financing programs. The program is more accurately described as "investor initiated life insurance"[1] because both the initiative for purchasing the policy and the source of funding are from outside investors or lenders who are totally unrelated to the insured. Potential insureds are asking, "Why shouldn't I do it?" and "What have I got to lose?", while advisors, insurance companies, regulatory organizations, and others should be studying the legal, financial, regulatory, and ethical issues involved.

Currently, there are dozens of non-recourse premium financing programs, and promoters are developing new programs and permutations almost daily.[2] Advisors must be able to assess the potentially significant risks of each non-recourse or recourse premium financing program in order to determine if the proposal is better than a free ice cream cone or is an attractive, but dangerous, iceberg that may sink their ship.

This article will (1) explore the iceberg-like features and risks of "free" life insurance arrangements, (2) suggest funding alternatives for clients whose primary objective is to purchase needed life insurance on a cost-effective basis, and (3) provide a checklist to assist advisors as they examine the details of particular "free" life insurance transactions.

The purported major benefit of non-recourse premium financing is to provide the insured with life insurance coverage for two years with no out-of-pocket cost—in other words, "free" insurance. Typically, the insured or the insured's trust[3] uses a loan to purchase life insurance that, in most cases, will

R. MARSHALL JONES is an attorney and President of R. Marshall Jones, Inc., a life insurance consulting firm, and Legacy Solutions Group, LLC, a family wealth planning firm, in West Palm Beach, Florida. He is a non-practicing member of the Florida Bar and holds the designations of Accredited Estate Planner, Chartered Financial Consultant, Chartered Life Underwriter, and Fellow of the Life Management Institute. STEPHAN R. LEIMBERG is an attorney and is CEO of Leimberg and LeClair, Inc., an estate and financial planning software company; President of Leimberg Associates, Inc., a publishing, software, and marketing consulting company in Bryn Mawr, Pennsylvania; and Publisher of Leimberg Information Services, Inc. which provides e-mail-based news, opinion, and information for tax professionals. He is also a former adjunct professor in the Masters of Taxation Program of both Temple University School of Law and Villanova University School of Law. He is a nationally known speaker on the topics of taxation and estate planning, and co-author, with Howard Zaritsky, of *Tax Planning with Life Insurance*. LAWRENCE J. RYBKA is an attorney and CFP®, and is President of ValMark Securities, Inc., an independent broker dealer based in Akron, Ohio, which specializes in working with independent insurance professionals across the U.S. He is a member of the Association for Advanced Life Underwriting ("AALU") and served as the insurance content expert for the CFP® Board of Examiners. Mr. Rybka has lectured and written extensively on estate planning.

be either (1) transferred to the lenders who often have informal arrangements to re-transfer the policy to a group of investors or (2) sold to a life settlement company[4] after the second policy year. Although the insured normally has an option to repay the loan and keep the policy, most programs are deliberately structured to discourage loan repayment and encourage divestiture so that at the end of two years, the policy ownership will be transferred to the lenders in satisfaction of the loan or sold to investors or a settlement company and they—not the insured's selected beneficiaries—will be the recipients of the policy's death benefit.[5] If, as expected, the insured chooses not to retain the coverage after two years, he or she can purportedly "walk away from the loan at no cost" and perhaps enjoy a profit. However, in many cases, the risks may outweigh the rewards.

How does non-recourse financing work?

The mechanics of the typical non-recourse premium financing transaction appear—at least on the surface—to be both relatively simple and benign. But, like an iceberg, a significant, and perhaps the most dangerous, portion of the transaction lies below the surface. It is therefore essential for advisors to carefully review all documents, authorizations, marketing materials, and representations to become aware of the legal, practical, and ethical implications.

Most "free insurance" financing programs are marketed primarily to individuals between age 72 and 85 who have a net worth of at least $5 million and the financial means to acquire large amounts of life insurance.[6] Marketers search for individuals with so-called excess insurability.[7] Ideally, these insureds will have mild health problems that will not be serious enough to discourage the insurance company from issuing a policy at standard or preferred rates, thereby increasing the investors' expected profit. (The sooner the insured dies, the greater the investors' profit!)

A typical 'free insurance' premium financing arrangement

An example of a typical non-recourse premium financing arrangement is shown in Exhibit 1, which depicts the planned sale of a policy to a life settlement company. Although there are many variations of these plans, the following steps provide a typical "above-the-surface" view of what a client and his advisor might see before carefully reviewing the documents.

Step 1. The prospective insured is promised one (or a combination) of the following if he or she qualifies for the program: two years of free life insurance; an up-front cash distribution of 1-1/2% to 3% of the death benefit (or a free luxury car);[8] a portion of the net profits from the expected sale of the policy to a life settlement company after two years or, in some instances, another 1-1/2% to 3% of the insurance benefit when the insured dies.

Step 2. The client secures a non-recourse premium financing loan from the lender to finance a life insurance policy.

Step 3. The proposed insured qualifies for the issuance of a $2 million or larger permanent life insurance policy.

Step 4. The third-party investor group makes or guarantees a non-recourse loan to the non-grantor irrevocable trust created to purchase the policy.

Step 5. As part of the policy purchase, the trust collaterally assigns the policy to the lender.

Step 6. After 24 months or longer, in order to satisfy both the

---

1 For additional information about these programs, see Silverman, "Letting an Investor Bet on When You'll Die—New Insurance Deals Aimed at Wealthy Raise Concerns," Wall Street Journal, p. D1 (5/26/05); Leimberg Information Services Estate Planning Newsletters 619, 670, 671, and 676; Davis, "Death-Pool Donations," 143 Tr. & Est. (May 2004); Leimberg, "Stranger-Owned Life Insurance—SOLI: Killing the Goose That Lays Golden Eggs," 32 ETPL 43 (Jan. 2005); Baldwin, "Free Insurance? Caution!," J. Retirement Plan. p. 5 (Mar.-Apr. 2005); Leimberg, "TOLI, COLI, BOLI, and Insurable Interests," 28 ETPL 333 (July 2001); Leimberg Information Services Estate Planning Newsletters 782 ("Proposals on SOLI, CHOLI, and COLI"), 818 ("Bill Attacks Snake Oil Salesmen"), 914 ("New York Insurance Department Opinion on Non-Recourse Insurance Transactions"); and Plevin and Silverman, "Investors Seek Profits in Strangers' Deaths," Wall Street Journal (5/2/06).

2 There are also recourse loan arrangements coupled with special trusts or partnerships designed to accomplish the same objectives.

3 This article refers to the insured as the policy owner. However, many transactions are structured so that the insured's portion of the insurance death benefit is owned by and/or payable to a "non-grantor trust," an irrevocable trust created especially for the premium financing transaction. Other programs may use limited partnerships or limited liability companies, instead of trusts, to own the policy and purportedly insulate the insured from tax and other liabilities.

4 A "life settlement" is the purchase of a life insurance policy by an investor while the insured is alive, and does not involve an insurable interest in the continued life of the insured. The investor benefits only from the insured's death. Typically, the policy owner-seller receives more than the cash surrender value of the policy as the primary inducement to sell the policy.

5 At a minimum, most programs include additional fees and payment requirements that make the repayment option much more expensive than a traditional loan. Even programs that make repayment a reasonable option typically include additional charges to provide the lender-investor with a 15% or greater compounded return.

6 This article later addresses the potential securities issues if the parties to the transaction are not accredited investors or if the promoters fail to comply with applicable securities laws and regulations.

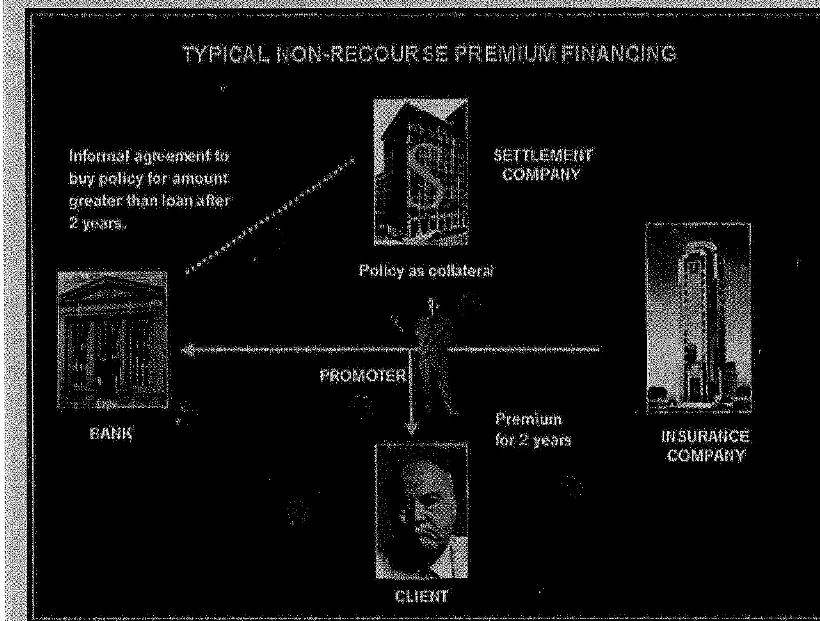
7 The promoters refer to "excess insurability" because they are looking for clients who do not want or feel they have a need to purchase any additional life insurance as part of their personal, business, or estate planning. For example, if the insured has a potential estate tax of $10 million and various insurance companies already have $4 million of life insurance in force on the insured's life, then the insured may have $6 million of excess insurability.

8 One promoter apparently placed a newspaper ad offering qualifying individuals two years of free life insurance and a Bentley!

policy's incontestability provision[9] and state insurance laws regulating the sale of newly issued policies, the insured's trustee chooses from the following options, if available:

1. Repay the loaned premiums with interest along with any cash advances, origination fees, termination fees or other charges; pay all future premiums and keep the policy; or
2. Sell the policy to a life settlement company; or
3. Transfer ownership of the policy to the lenders in full satisfaction of the loan.

EXHIBIT 1
Typical Non-Recourse Premium Financing



What are the risks associated with non-recourse premium financing transactions?

When looking below the surface of a non-recourse premium financing transaction, a thorough review of the mechanics of the transaction may uncover undocumented or ignored elements that may (1) constitute a violation of state insurance law or regulations; (2) raise significant securities regulation and litigation issues; and (3) trigger unexpected tax risk, financial exposure, litigation risk, and, in some cases, potential criminal penalties. When navigating a client through a non-recourse premium financing transaction, advisors should be wary of the icebergs that could sink their ship:

Violations of state insurance laws and regulations

'Free' insurance and the 'insurable interest' rule. Third-party investors offer the insureds two years of "free" insurance because it is illegal for them to purchase insurance on the life of an individual unless the original applicant-owner has an insurable interest at the time the policy is purchased. Without an insurable interest, the policy would be void from inception and the death benefit will not be paid to the investors.[10] To protect the public, all states have insurable interest statutes designed to discourage speculation on an insured's life.[11] Generally, the initial owner and beneficiary must have a strong economic interest in, and benefit from, the continued life of the insured. For example, family members are generally presumed to have an insurable interest in their spouses and parents.

The promoters apparently believe that an initial purchase by the insured, followed by a 24- to 30-month time lapse between the policy's issue date and its subsequent transfer of ownership to the investors (or a life settlement company), will avoid an insurable interest challenge.[12] Nevertheless, legal theories such as "form over substance" or the "step-transaction"

[9] Each policy contains a provision that basically says that after the policy has been in force for two policy years, the insurance company may not cancel the policy due to any misstatements or misrepresentations made by the insured.

[10] Obviously, courts will examine the actions of the insurer, the insurance agent or broker, and other parties. In some cases, the courts may bar the insurer from asserting a lack of insurable interest if those actions—or failures to act—constitute a waiver by, or an estoppel against, the insurance company.

[11] Insurable interest laws vary widely from state to state. A summary of a more liberal and broad insurable interest law reads, in part, as follows: Insurable Interest as to personal insurance means that (1) every person has an insurable interest in him or her self; 2) in the case of individuals related by blood or law, a substantial interest engendered by love and affection; 3) an employer has an insurable interest in an employee to the extent of economic loss; 4) a party involved in an option or contract to purchase or sell a business has an insurable interest in the other parties to the transaction; 5) a trust has an insurable interest in the life of the grantor or anyone else who is treated as owner of such trust for federal or state income tax purposes or in that the trust beneficiaries have an insurable interest in the grantor; 6) a creditor has an insurable interest in an insured's life to the extent of the debt insured. Del. Gen Stat. Title 18 § 2704. See www.leimbergservices.com under State Laws for a summary of every state's insurable interest laws.

[12] In addition, the investors intentionally structure the "free" insurance period to extend beyond the two-year contestability provision of the insurance contract and with the intent to avoid running afoul of each state's prohibition against the sale of life insurance as "wet ink" viatical transactions.

or "agency" doctrines may be used to assert that the insurable interest provision was not satisfied and the insurance contract is void.

On 1/9/06, the New York State Insurance Department announced that a proposed premium financing transaction violated the state's insurable interest law and was not permissible under New York Insurance Law.[13] If the insurable interest law is violated, the insured, the insured's trust and estate, and their agents and advisors may become embroiled in unexpected litigation. This could occur either during the insured's lifetime or after death.

Although this is only an Opinion and if binding, only binding in New York State, the authors feel it will be highly persuasive in other jurisdictions. The insured under the facts of that Opinion had a "put," a right to require the put provider, a hedge fund, to purchase the policy from the client at his request on the exercise date and pay an exercise price equal to a pre-determined formula, the sum of which would cover the repayment of the loan by the client, as well as loan interest. Some have claimed that this distinguishes their situation since they don't use "puts." Although the put was clearly a "smoking gun," the authors believe the Office of General Counsel would have concluded that there was a lack of insurable interest even without it.

Fraud and misrepresentation by the insured. The standard life insurance application requires insureds to sign written statements regarding their health, financial circumstances, policy ownership, and the purpose of the insurance. Companies rely on this information as part of their consideration for issuing coverage. The answers to most of these questions become part of the contract.

Most life insurance contracts provide that the policy may not be contested by the insurance company after two policy years.[14] For more than 100 years, the incontestability provision has helped maintain public confidence that the death benefit will be paid as promised to the beneficiaries without delay or challenge. Meanwhile, the provision gives the insurance company a reasonable two-year period to rescind the life insurance contract if it discovers any undisclosed or misrepresented facts that rise to the level of a "material misrepresentation" that would have kept the policy from being issued as applied for.[15] After two years, the validity of the insurance contract may be challenged only in a narrow set of circumstances based on law that varies from state to state.

At this point, the insured may ask, "Why should I care about these issues?" The answer is submerged in the murky fine print in the mound of documents the insured signed—the indemnification provisions for this "free" insurance!

A standard part of "free insurance" premium financing transactions is an indemnification provision whereby the insured agrees to indemnify the lenders and investors for any loss resulting from a material misrepresentation or omission. The insured, or the insured's family, may be liable for the investors' loss—potentially the multi-million dollar death benefit that was not paid to the investors—if any misrepresentation of these items is discovered during the contestable period. If the misrepresentation is intentional and material, it may give rise to fraud that extends beyond the contestable period.

In particular, fraud constitutes one of those narrow circumstances that have allowed companies to contest a policy beyond the two-year period. If the insurance company chooses to contest the policy, these contract provisions could trigger indemnification liability, plus the time and expense of litigation, and the possible charge of felony insurance fraud.

With an allegation of fraud and a subsequent policy contest, the outcome could be even more uncertain if the beneficiary was an investor and the documentation showed a purposeful misrepresentation of true ownership by the insured or an undisclosed intent to transfer the policy from its inception. When misrepresentations and omissions rise to the level of fraud, the insurance company may have a right of rescission that continues beyond the insured's death.[16]

If the insured, the insurance broker, or the insured's advisors fail to answer fully the questions on the applications, medical forms, oral interviews, inspection reports and other documents, the insurance company may be misled into issuing a policy that the insurer can later argue is void and unenforceable.[17] The insured is responsible for verifying these statements before signing the application. If the insurer successfully contests the death claim, the investors may seek to recover from the insured, the trust, or the estate under the investor indemnification provisions regarding material misrepresentations or omissions.

How could this happen? First, there may be a significant risk of mate-

[13] See "Opinion from the Office of the General Counsel," 12/19/05, representing the position of the New York State Insurance Department, published 1/9/06.

[14] Each state has its own incontestability provision designed to assure the payment of benefits on validly issued policies. A typical incontestability clause stops the insurer from contesting the death claim after the policy has been in force for two years. See "The Incontestable Clause in Life Insurance Policies—A Statute of Limitations, But Not a Confession of Judgment," 7 Newark L. Rev. No. 2 (June 1942), for the traditional approach to the question. Also see Link, "Viatical Settlements: What Do the Courts Have to Say?," presentation at the ABA Tort and Insurance Practice Session (1/11/01), for a more contemporary discussion of the issue.

rial or fraudulent misrepresentations and omissions when both the insured and the investors are seeking nothing more than minimum technical compliance with the insurable interest law. In reality, there is only a temporary or nominal "insurable interest" disguising the true intent of the transaction to pass ownership to the investors.[18] An incomplete or misleading answer by the insured or by others on behalf of the insured—though not intentionally fraudulent—may be sufficient to create liability.

Second, the insured may not be aware of his or her representatives' material misrepresentations or omissions even after a careful review of every aspect of the transaction, including every statement in the application. For example, it is standard practice for the insured to provide verbal answers that are recorded by others. On the application and medical forms, the insured's signature is a representation that the information provided is true and correct to the best of the insured's knowledge and belief.

Once it became apparent that many non-recourse premium loans were, in reality, a disguised means of settling new policies with investors, an increasing number of U.S. insurance companies created internal policies to identify and prohibit these transactions. Some companies included new questions in their applications, agent reports, and personal interviews to help identify these transactions and deny coverage. The following are the sort of questions found on the life insurance applications of insurers who disapprove of non-recourse premium financing transactions:

- Is there any intention that any party, other than the owner, will obtain any right, title, or interest in any policy issued on the life of the proposed insured as a result of this application?
- Is there any debt being used to finance this policy? If so, provide complete details as to the terms and parties involved.

Even for those who accept the other risks associated with these transactions, it is certainly unethical and probably criminal for any promoter to "coach" the insured to answer questions in anything other than a complete and accurate manner.[19]

Rebating. Another area of risk to insureds is the use of cash incentives to purchase the policy. The New York State Insurance Department General Counsel Opinion, citing lack of insurable interest for one of these transactions, also made the point that free insurance might constitute an illegal rebate.[20] Most state insurance regulations either prohibit or severely restrict the offer of rebates to clients who buy insurance. The few states that allow this practice require that any rebates fit within specific parameters established by the state. Settled case law holds that life insurance rebates are generally non-deductible by the payor and taxable income to the recipient.[21] Clearly, any offer of cash, cars, or any other similar inducement could constitute a taxable rebate.

In addition to unfavorable taxation, the characterization as a rebate increases the insured's risk of liability. While most insureds may see this only as a technical violation of the law by the person selling the insurance, it has potentially adverse consequences for the owner as well, including the voiding of any professional liability insurance in the transaction. This would make monetary recovery against the broker or agent, in the event of a lawsuit, less likely.

Violations of state insurance statutes on 'wet ink' viaticals. Many states have enacted model statutes prohibiting the sale of life insurance as an investment for the benefit of a disinterested third party. Furthermore, to guard against so-called wet ink viatical transactions (i.e., the sale of a newly-issued policy to a life settlement company "almost before the ink is dry"), the National Association of Insurance Commissioners' ("NAIC") Viatical Settlements Model Regulation has been adopted by a number of states to prohibit the sale of insurance policies within 24 months of the policy issue date.[22] This restriction applies to both policy owners and licensed life insurance agents and brokers. There are two risks involved:

First, unless the state where the policy is issued has provided a written opinion to the contrary, the "free" insurance transaction may be invalid as a "step transaction"

[15] See, e.g., Chawla v. Transamerica Occidental Life Insurance Co., 440 F.3d 639 (CA-4, 2006), *aff'g in part* 2005 WL 405405 (E.D. Va., 2/3/05).

[16] See, e.g., Horowitz v. Federal Kemper Life Assurance Co., 57 F.3d 300 (CA-3, 1995).

[17] It is not sufficient to rely on the promoter's assurances that the insurance company knows all the details and has approved the transaction. Even those relatively few insurance companies that have intentionally allowed policies to be issued with non-recourse premium financing have also refused to "endorse" or "approve" the promoter's program or the specific transaction. The advisor and the insured must confirm and document that full disclosure has been provided in the event the insurance company subsequently decides to file an action to void the contract or deny the death benefit. See SEC v. Mutual Benefits Corp., et al., 408 F.3d 737 (CA-11, 2005), and the accompanying state actions on this case for examples of legal transactions involving fraudulent applications. See also the fraud provisions of the NAIC Viatical Settlements Model Act, ¶ ¶ 1F(1) and 1F(2)(4).

[18] For instance, as the Office of the General Counsel Opinion for the New York State Insurance Department noted, "The policies are arguably not obtained on [their] own initiative as required by New York Insurance Law."

[19] Query: Does the trust or other entity have a *Chawla*-type insurable interest issue? See note 15, *supra*.

[20] See note 13, *supra*.

violation of the state's prohibition of wet ink viatical sales.

Second, the "free insurance" transaction may provide additional grounds beyond contract law for the state or the insurance company to invalidate the transaction as an illegal "intent to settle"—i.e., a disguised, illegal life settlement transaction in violation of the insurable interest rules.[23]

Proving intent can be difficult. It can be expensive to defend, too! What are some of the factors that might evidence an illegal intent to settle? Here are a few:

- The insured's signed authorization permitting a subsequent sale to a life settlement company.
- The almost universal presence of a life expectancy evaluation before the loan is granted to predetermine the value of the policy to the investors.
- The profit motive for the insured and the other investors detailed in a careful reading of the documents.
- Marketing materials describing the insured's financial benefits for allowing the investors to use his or her "excess insurability."
- Letters and e-mails from advisors and promoters detailing the steps to follow to benefit from the transaction.
- The reality that the original "insurable interest" owner rarely—if ever—intends to, or actually does, repay the loan and accrued interest, pay future premiums, and keep the policy.
- The overall facts and circumstances show the insured participated in the investment of money in a common enterprise involving an expectation of profits based solely on the instigation and efforts of a third party or parties.[24]

Potential securities law issues

Potential violations of federal or state securities law. In addition to insurance law issues, advisors must consider these programs as possible securities transactions. Insureds, their advisors, and insurance agents/brokers may face significant, long-term financial exposure if the non-recourse premium financing transaction is a security but not structured to be fully compliant with federal and state securities laws.

One of the more serious and often overlooked transaction risks is the possibility that the insured, the trustee, and the advisors are participating in the issuance, sale, or solicitation of unregistered securities in violation of sections 5(a) and 5(c) of the Securities Act of 1933. This risk should cause great pause because transactions falling under securities law may require very specific disclosure in the transaction and many additional statutory remedies.

In May 2005, the Eleventh Circuit affirmed a U.S. District Court finding in *SEC v. Mutual Benefits Corp.*[25] that "...these viatical settlement contracts qualify as 'investment contracts' under the Securities Acts of 1933 and 1934...." As a result, the directors and officers of the Mutual Benefits life settlement company were subject to both civil and criminal penalties for the illegal sale of unregistered securities and securities fraud.

The insured may think, "I haven't done anything wrong if I sell my policy two years from now and receive part of the proceeds." Similarly, most advisors and life insurance agents will argue that they are merely selling insurance. However, when the entire transaction is viewed from a broader perspective, it has all the elements of an investment under the classic *Howey*[26] test:

- An investment of money,
- With the expectation of profit,
- Based solely on the efforts of a third party or parties.

Indeed, prior to the *Mutual Benefits* case, the investment firm UBS carefully packaged several blocks of life insurance contracts as private placements under the acronym of "LILAC" ("life insurance leveraged annuity contracts"). Most promoters have not been so careful. Now, after the *Mutual Benefits* decision, the costs of being wrong on this particular issue are even higher. There is added risk of not only an unlimited right of rescission of the transaction for investors, but also the possibility of criminal prosecution. The securities classification risk is even higher if the "loan" comes from a securities-regulated entity, such as a hedge fund. In addition, the representations made to the hedge fund by the client, trustee, or promoters may give a cause of action to the hedge fund and its ultimate investors as in *Mutual Benefits*. Moreover, any misrepresentations can give rise to a claim of securities fraud by the insurance company, lender, or third-party investors.

Prior to the *Mutual Benefits* case, the settlement industry consistently cited a district court decision, *SEC v. Life Partners, Inc.*,[27] as the basis for insurance regulation of the settlement business. Despite the *Life Partners* decision, the SEC has persisted in its opinion that investments in settlements are securities. The precedent of the *Mutual Benefits* case creates a cavalcade of

[21] Haderlie, TCM 1997-525 ; Wentz, 105 TC 1 (1995).

[22] NAIC Viatical Settlements Model Regulation Rev. 3/16/04; 27 states have adopted the NAIC Viatical Settlements Model Act, and it is pending in eight others. Section 10 provides, "It is a violation of this Act for any person to enter into a viatical settlement contract with a two-year period commencing with the date of the issuance of the insurance policy or certificate...."

potential securities issues for everyone in the chain of the transaction.[28] Competent securities counsel should be part of the team assessing the risk of any non-recourse premium loan or life settlement transaction.

The risk of failure to comply with the Patriot Act. Some countries have more favorable tax laws regarding investor-owned life insurance that make U.S.-issued life insurance policies particularly attractive. Consequently, foreign investors have entered both the non-recourse premium financing market and the life settlement arena. For any transactions funded by entities outside the U.S., the insured's advisors may need to help the insured and the trustee stay fully compliant with anti-money laundering regulations and the Patriot Act.

Tax risks

Along with the insurance and securities law risks, clients and advisors must consider how the transaction will be taxed. There are many uncertainties here as well, as the following discussion illustrates.

The unknown tax cost of the unpaid loan. There does not appear to be any clear or certain guidance regarding the tax consequences related to non-payment of the loan. For example:

- If the insured decides to "walk away" from the policy at the end of the second year and transfer it to the lender in full satisfaction of the debt, is there reportable income and, if so, in what amount for the forgiveness of debt?[29]
- Is there taxable income or gifts to the trust or trust beneficiaries for the annual value of the insurance protection during the two years that the trust owns the coverage? If so, how is it measured and reported?[30]

An argument can be made that any "free" insurance benefit should be taxed as ordinary income and that income tax may be due on 100% of any forgiven loan balance, including all accrued interest and any waived fees or charges. The tax opinions will vary from advisor to advisor and from transaction to transaction.

On behalf of the insured, tax counsel might argue the position taken by some promoters in their marketing materials: that the loan obligation is real and the investors intend to enforce it by either (1) requiring full repayment or (2) transferring policy ownership in full satisfaction of the loan. In the opinion of the promoters' attorneys, any gain to the insured will be taxed, if at all, as a long-term capital gain transaction.[31]

Conversely, the IRS might argue that the insured paid nothing for the insurance and has received a taxable economic benefit. The IRS might also argue the insured also received an illegal rebate in the form of free insurance, cash or other compensation, and was an investor in the transaction. As the recipient of an illegal rebate, the insured may be liable for ordinary income tax on the value of all benefits received, including the value of any initial inducements, advances, and the total amount forgiven.

The *Sutter*[32] case bolsters that potential IRS position. In *Sutter*, the Tax Court held that Mr. and Mrs. Sutter must include, as income, the total premiums paid for the "free" insurance that was funded by an agent's commission leveraging scheme. In this case, the agent set up a financing company to loan the first year premium on a non-recourse basis. The agents received commissions in excess of the loans, and the insureds received free insurance. The insureds then allowed the policies to lapse at the beginning of year two. The Tax Court held that the taxable value of the "free" insurance was the premiums paid.[33]

In the past, an insured might ask his or her attorney for an opinion letter for protection against penalties in the event of an IRS challenge. With the publication of IRS Circular 230, however, an opinion letter may be either unavailable or prohibitively expensive. It may expose other parties in the transaction to IRS penalties as well.[34] The authors haven't seen any "more likely than not" opinion letters from insured clients' counsel affirming the tax and non-tax claims of promoters of "free" insurance.

Additional tax risks—charitable variations of investor-initiated life insurance ('IILI'). Investors are also involving charities in their efforts to acquire life insurance policies that would not otherwise be available because the investors lack an insurable interest in the insureds. One variation of non-recourse pre-

[23] In its advisory opinion, New York State said, "...it appears that the arrangement is intended to facilitate the procurement of policies solely for re-sale. It is our view that a plan of this nature does not conform to the requirements of New York Insurance Law." Office of the General Counsel Opinion, *supra* note 13.

[24] See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293 (S.Ct., 1946), and SEC v. Edwards, 540 U.S. 389 (S.Ct., 2004), regarding whether a transaction involves a "security" or an "investment contract" covered by the Securities Act of 1933 and the Securities Exchange Act of 1934.

[25] SEC v. Mutual Benefits Corp. et al., 408 F.3d 737 . (CA-11, 2005), *aff'g* 323 F. Supp. 2d 1337 (S.D. Fla., 2004). Technically, a viatical settlement is a life settlement transaction involving insureds with a life expectancy of less than 24 months. In the opinion of the authors, the finding in the Mutual Benefits case applies to all life settlement transactions, including the possibility that many—if not all—non-recourse premium financing transactions may be classified as disguised life settlements.

[26] SEC v. W.J. Howey Co., 328 U.S. 293 (S.Ct., 1946).

mium financing transactions involves promising modest benefits to a charity or university in order to market to its list of wealthy older donors and alumni.[35] This allows the promoters to identify clusters of potential insureds through a single source. The promoters typically convince the donors to allow the investors to use their "excess insurability" by promising the charity an expected payment estimated at 2% to 5% of the eventual death benefit after payment of all expenses and a guaranteed profit to the investors. In essence, the charity is paid a modest finder's fee. Meanwhile, the charity may not be aware of its potential exposure under the securities laws, the potential 100% excise tax on money going into one of these schemes,[36] the potential harm to its reputation, or the risk to its tax-exempt status.

The risk of estate tax on the death benefit. Because the investors are looking for insureds with a projected life expectancy of 120 months (ten years) or less, advisors must evaluate the risk that the death benefit will be included in the insured's taxable estate if he or she dies during this period. For example, do the mechanics of the loan and any options or veto rights given to the insured or his trustee constitute retained powers under IRC Section 2042, or other Code sections, causing inclusion of the policy in his or her estate? If Section 2042 applies, is there a possibility that Section 2035 may also apply when the policy is transferred to the investors? This can add three years to the risk of estate inclusion.

Furthermore, if the insured must approve the transfer of the policy to trigger loan forgiveness or to repay the loan, will this possibility include the policy in the insured's taxable estate under IRC Section 2042 or 2036 until the transfer and thereby cause Section 2035 to apply? If the insured has a sincere desire to continue this life insurance as part of his or her estate plan (as opposed to selling the policy for a profit), the added tax risk of inclusion in the estate is a high price to pay for this flexibility.

Practical considerations

In addition to the tax, regulatory, and liability risks with these transactions, there are other potential drawbacks. Some are documented in the details of the transaction. In fact, most of the programs require the insured and the trust to formally acknowledge certain transaction costs, including the following.

Confidentiality and qualifying for the non-recourse loan. The investor group will require your authorization to obtain your client's medical records, evaluate your client's life expectancy and, assuming the loan is not repaid, have the right to continue to monitor your client's health until the death benefit is paid. While the insurance company wants your client to live a long time, the investors want your client to live only more than two years from the date the insurance becomes effective. Because many of these arrangements allow re-sale to a group chosen by the lender or investors, there is no way to guarantee that these buyers have adequate safeguards to protect the confidentiality of the client's health information and to prevent or veto the re-sale of the policy to undesirable individuals or groups.

Although the risk of an investor arranging for an insured's death may be very slim, it is greater when the owner-investors may sell or re-sell their policies to individuals or other parties without complying with the confidentiality safeguards required of reputable institutions. Also, there are "clearly litigated cases where one party has procured life insurance on the life of another, and then engaged in nefarious, life-altering actions to facilitate the death benefit payments under the policy."[37]

The cost of repaying the loan and keeping the policy. It is very unusual for an insured to participate in a "free insurance" premium financing program with the primary intent of repaying the loan after two years and keeping the insurance for the originally stated "insurable interest" purpose. In general, the purpose of the repayment option is to give apparent legitimacy to the insurance transaction and not to encourage repayment. In fact, the insured usually has lower-cost private or commercial recourse financing available as an alternative. The decision to use higher-cost non-recourse financing is yet another indication that the insured never intended to pay premiums after the second policy year.

Even the most compliant and professional non-recourse premium financing programs general-

[27] SEC v. Life Partners, Inc., 87 F.3d 536 (CA-D.C., 1996), *rehearing den.*, 102 F.3d 587 (CA-D.C., 1996).

[28] For an expanded discussion of these issues, see Rowland, "The Brewing Storm: Securities Regulation and Lifetime Settlements," J. Financial Service Professionals, pp. 76-84 (May 2003).

[29] See Gans and Soled, "A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference" (to be published), which notes that the IRS may take the position that "The Participant's basis in a life insurance policy must be reduced by the entire acquisition cost." Therefore, "the basis is likely to be very low at the two year point—indeed most of the premium is typically devoted to such costs during the policy's early years."

[30] Some analysts suggest that, at a minimum, these transactions will be governed by the split-dollar Regulations, with annual reportable income determined under either the economic benefit regime or the loan regime for each year that a death benefit is provided until the loan is repaid or cancelled.

ly expect to earn at least a compounded 15% return on equity for the investors. Many programs impose a much higher actual cost of repayment through a combination of exit fees and other charges to dramatically discourage repayment. While a violation of state usury laws does not create direct liability for the insured participating in the transaction, the high rate of interest charged should give pause for advisors to review the economics and give added weight to the concern that the transaction may actually be classified as an investment governed by the SEC.

The 'zero future insurability' risk. Does the insured clearly understand that the use of his/her "excess insurability" may do more than prevent him/her from obtaining additional insurance in the future? It may also prevent the insured from replacing his or her personal and estate planning insurance if updates are desired. In a tightening reinsurance market, the total of all insurance—both existing and applied for—is used to determine the amount of new or replacement insurance available. While this is almost universally disclosed in the documents for these transactions, the implications—especially with regard to replacement coverage—may not be fully understood.

The lack of errors and omissions coverage risk. The many regulatory issues identified above are heightened for an advisor with an insurance or securities license. All professional liability policies have prohibitions and coverage exclusions for transactions involving rebating, "wet ink" transactions, providing false information to insurance companies, and securities violations. In addition, most liability policies exclude coverage for any work involving settlements or viaticals. In the event of a problem, the insured and his or her trust are not likely to be able to look to the promoter's errors and omissions coverage for recourse because most of these issues fall outside the policy coverage as exclusions. Thus, the advisors and, ultimately, the insureds will bear these risks alone, and clearly, the insureds who qualify for and participate in these transactions have much to lose.

What options should advisors consider and what should they recommend to clients?

Reputable agents with clients whose primary objective is to acquire permanent life insurance as part of their estate plan will continue to ask with regard to premium funding, "Are there any 'good' non-recourse premium loan transactions that adequately address the risks and preserve my client's options?"

Even if clients and advisors can get comfortable with a particular transaction from a legal, tax, and regulatory point of view, and have reasonable certainty that the transaction does not pose significant liability, traditional planning techniques may offer lower costs to provide insurance coverage with far more certainty and less potential litigation liability. For example, assume that a 75-year-old man wants to purchase $10 million of life insurance for estate planning purposes. For comparison with non-recourse premium financing loans accruing at 15% per year, the advisor might consider the following options:

- *Alternative #1: A high early cash value policy.* The client could purchase a high cash value product instead of non-recourse premium financing. The annual premium on this policy is $675,373. After two years, the client will have paid a total of $1,350,746 in premiums. If, after two years, the client decides he no longer needs insurance coverage, he can surrender the policy for $1,114,063—the cash value at the end of policy year two. This enables him to walk away with a net balance sheet cost of only $236,683 for the two years of insurance plus the option of continuing it. By choosing a traditional alternative, the client has the additional option to keep the insurance after year two simply by paying the year three premium, because there is no loan to repay.
- *Alternative #2: A minimum premium guaranteed universal life ('GUL') policy with a 'catch-up' option.* With this alternative, the

31 Some transactions are structured to disguise the loan and treat the insured as an investor in a partnership or limited liability company. In those cases, the insured's investment interest terminates at the end of policy year two when the insured chooses not to purchase the other investors' interests.

32 TCM 1998-250.

33 The solution recommended with some non-recourse premium transactions is to draft a non-grantor irrevocable trust to isolate any tax liability within a trust whose only asset is the insurance policy. After two years, the trust signs over the policy in full payment for the loan, leaving the trust with no assets to pay any income tax or penalties. The promoters tell the insured this will insulate him from personal liability. However, this may give rise to a potential IRS tax shelter attack, particularly if anyone other than the client's attorney makes this recommendation. It may also be considered a conspiracy to evade income tax.

34 Circular 230 (Rev. 6-2005) (31 C.F.R. Subtitle A, Part 10 revised as of 6/20/05) basically allows the IRS to hold accountants and attorneys legally responsible not only for what they present in their tax and legal opinions, but also for any omissions of material information.

35 In North Carolina and Texas, for example, legislators changed the definition of "insurable interest" to allow charities and other tax-exempt entities to participate in IILI transactions. In other states, lobbying continues with key legislators to change the insurable interest law and allow IILI transactions for their favorite charity or university.

36 The Senate passed S 20-20 which would impose a 100% federal excise tax, retroactive to 5/4/05, on charitable death benefits associated with versions of investor-initiated life insurance. On 5/8/06, the Board of The American Council of Life Insurance ("ACLI") voted 26 to 4 in favor of a 100% excise tax on the resale of life insurance policies less than five years old.

client could pay the minimum premium required to purchase a GUL policy with a catch-up provision. The premium catch-up provision would allow the client to extend the policy's premium and death benefit guarantees either to a designated age or for life.

In this example, the minimum annual premium to maintain the policy for two years is $279,655. If, after two years, the client decides that he no longer wants the insurance, he can walk away, having paid total premiums of only $559,310. However, if the client decides to keep all the insurance, he can "catch up" to an age 100 guarantee by paying level annual premiums of $477,570 beginning with policy year three.[38] By comparison, if the client is allowed to repay the non-recourse premium financing loans, the cost to continue the policy will include not only the premiums and the loan repayment, but also the accrued interest and any other charges imposed by the lender-investor.

• *Alternative #3: Second-to-die convertible term insurance.* If the 75-year-old man is married and his wife is also age 75, they can apply for a survivorship life ("second-to-die") policy. Some carriers offer this type of policy on a term basis with an option to convert to permanent insurance later. In this scenario, the client would purchase a second-to-die convertible term policy with an annual premium of $77,100. If, after two years, the client decides he no longer needs the insurance, his total cost is only $154,200.

On the other hand, if the client decides to keep the insurance, he can convert the term policy to permanent insurance in year three without taking a new medical exam or providing any additional underwriting information because the conversion to a permanent policy is contractually guaranteed. The premium on the converted permanent insurance is $297,772 annually, making this the least expensive option. In addition, most estate plans defer the payment of estate tax until the second spouse's death, making second-to-die coverage the policy of choice to provide tax-free cash when it is needed.

• *Alternative #4: Non-recourse premium financing.* In a "clean," "fully disclosed" premium financing transaction, the client would take out a premium loan on a non-recourse basis. Using the numbers in the earlier example, when the premiums, loan interest, loan insurance, trust fees, and exit fees are factored into the loan, the client would be faced with a repayment obligation of $1,434,523 and out-of-pocket origination fees of $14,064.

If the client does not want the insurance after two years, his costs will include both the amount paid in origination fees and income tax on some or all of $1,434,523 when the loan is forgiven. Assuming a 35% tax bracket, the client could pay as much as $502,083 plus $14,064 in fees—a total cost of $516,147. However, if the client decides to repay the loan after two years and keep the insurance, he or she must repay $1,434,523 plus the year three annual premium of $442,838. In this example, the client's three-year average outlay after repaying the loan is $630,475.

What is the driving force behind these 'free' insurance transactions?

Considering all the potential drawbacks and the attractive alternatives that offer the same flexibility without the risks, one might ask, "Why would anyone consider one of these transactions?" The first word that comes to mind is "greed." Promoters of these "something for nothing" insurance schemes expect to earn millions of dollars in commissions by selling and then re-selling large amounts of insurance. Similarly, greed can induce clients to act on the promise of something for nothing without an adequate understanding of the risks. It is natural to seek out the "best deal," but advisors must also ask, "Is the best deal the right deal for my client and what are my potential exposures?"

A checklist for non-recourse premium financing transactions

The following list of questions, although not comprehensive, can help clients and advisors analyze most non-recourse premium financing transactions:

1. Is there any direct, indirect, or potential violation of the applicable state's insurable interest rules?[39] (Consider who might have and who has standing to bring this issue up.)

2. What is the risk of the policy being contested due to a material or fraudulent misrepresentation or omission by any party in the transaction?

3. Will the two-year incontestability provision be unenforceable due to either lack of an insurable interest or compelling circumstances, such as fraud or adverse impact on the public interest?

4. What indemnification provisions have the client or the trustee signed that might make the insured, the insured's trust or the estate liable for the investors' losses if the death benefit is not paid?

5. What is the potential for, and estimated cost of, litigation with the insurance company, the SEC,

37 See Harrison, "Casey Jones, Who's Driving That Insurance Train," a very thorough paper presented at the 2005 ACTEC Summer Meeting. See also DiMassa and Winton, "Two Arrested in Homeless Life Insurance Scam. Pair are accused of obtaining policies on two men who later died in hit and run accidents," LA Times (5/19/06).

the state attorney's office, the IRS, the investors, or disinherited beneficiaries?

6. Are there any cash payments or other inducements that may be treated as (1) illegal payments to an unlicensed insurance agent, (2) illegal rebates, (3) benefits making the insured an "investor" subject to civil or criminal penalties under securities law, or (4) payments making the insured liable for improperly participating in a private securities transaction?

7. Have all parties—insured, trustee, advisors, and insurance agent/broker—made full disclosure of all requested and relevant details to the insurance company and its representatives?

8. Is the insured both aware of, and comfortable with, the loss of confidentiality regarding his or her health status and medical records until the death benefit is paid to the investors?

9. Does the program violate the state's prohibition on viatical settlements as an illegal "intent to settle" or as a two-year "step transaction"?

10. Do the marketing materials—including faxes, correspondence, and e-mails—increase the risk that the transaction may be challenged by the state insurance department, state or federal attorneys, the SEC, unhappy future owner-investors, or others?

11. Is the loan truly non-recourse or do transaction circumstances or details create a recourse loan situation? Does the fact that the arrangement is structured as a recourse loan make a meaningtul difference in the outcomes?

12. What are the tax costs for any benefits received, insurance provided, and loans forgiven?

13. What is the full repayment cost if the insured decides to keep the insurance? Does the transaction make ecomonic sense? Will the client, after all costs and tax exposures, and lacking a guaranteed market at a set price, make or lose money? How do you know?

14. Does the transaction (including any subsequent re-sale) constitute the illegal sale of an unregistered security with potential liability against everyone who assists or participates in the transaction?

15. Will a 100% federal excise tax be imposed in the case of a charity?

16. Is a participating charity risking its reputation or tax-exempt status in the transaction?

17. Will the death benefit be included in the insured's estate?

18. Is the insured comfortable with giving up the right to purchase new insurance and to replace existing insurance for his or her own personal planning?

19. Does the transaction comply with the Patriot Act?

20. What risks to the advisor's reputation and liability are associated with the transaction?

21. Will the transaction be covered under the errors and omissions insurance policy of the advisor, insurance agent, or broker?

22. Is the advisor comfortable legally and ethically with the transaction?

23. Is it the right thing to do?

By being fully informed of what lies beneath the iceberg of non-recourse premium financing, advisors and their clients can arrive at the best solution—personally, legally, and ethically—for all concerned. ■

38 If the insured's advisors can accurately estimate life expectancy, they may recommend paying a lower premium in order to maintain the death benefit for a reduced number of years instead of age 100 (or longer).

39 Some states are revising their laws to prohibit investor-initiated life insurance as a violation of the insurable interest, viatical settlement, and life settlement rules.