DISGUISED TAX-AVOIDANCE AND OTHER INSURANCE-RELATED ISSUES

By Peter Katt

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Starting with this column, I will periodically update readers on issues or ideas previously raised and briefly present issues or ideas that don't warrant an entire column.

The false promise of some developers and sellers of certain insurance/retirement plans is the proffered pairing of tax-deductible contributions and tax-free benefits. It is false because this combination isn't possible in the real world. The preferred vehicle for such plans is life insurance because its inherent complexities lend themselves to the various contrivances used. Also, life insurance's extravagant commissions encourage the creation of these kinds of plans in the first place.

One type of retirement/insurance scheme involves full disclosure of the steps utilized, even though the critical step incorporates a transaction whose only function is to create the desired result without any substance. An example of this is a plan that flourished in the 1980s and early 1990s known as leveraged split-dollar. Leveraged split-dollar was sold primarily to medical and dental professional corporations. The critical step was a phony policy loan between the insurance company and the professional corporation. This bookkeeping-entry transaction was an attempt to justify tax-deductible plan contributions because it was dressed up to resemble corporate interest payments that are deductible. In 1995, the Tax Court determined that no legitimate loan was created, and that the whole effort was a tax-avoidance scheme. The Tax Court imposed a very harsh ruling on the taxpayers involved, denying the corporations a deduction for the phony loan interest payments and including a like amount in their personal income as constructive dividends. Taxes, penalties, and interest were greater than the actual premiums!

Another type of device used by the developers of such plans is to hide the subterfuge away within otherwise legitimate employee benefit plans [such as Voluntary Employee Benefits Association] that have real tax advantages, hoping the IRS doesn't find the offending elements—at least until they have earned their tremendous profits. One version, for instance, uses life insurance with a two-stage process. The first stage insures participants with what the promoters claim is term insurance with a death-only benefit that is entitled to a tax-deduction, but the premium cost is some 10 times higher than normal. After four or five years, this so-called term insurance is transferred to the insured, becoming the sole property of the insured. While the insurance policy is impersonating term insurance, it has no value. However, once it has been transferred to the insured, it magically generates soaring cash values without the payment of any further premiums. It is these cash values that fund the tax-free retirement income and the paid-up life insurance. The sellers of this retirement/insurance plan promised buyers tax-deductible costs, pre-retirement term insurance, tax-free retirement income, and post-retirement paid-up life insurance. However, it wasn't long before the IRS noticed that the so-called term premiums were excessive and issued tax deficiency notices to some 30 policy owners. The Tax Court eventually ruled that the contributions in

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excess of true term costs were not tax-deductible and must be picked up as dividend income. As was the case with the leveraged split-dollar schemes, the taxes, interest, and penalties were more than the original plan contributions.

The problem with these retirement/insurance schemes is that they are often considered professionally legitimate and treated respectfully in the insurance industry. In addition, the schemes don't disappear—they come back dressed up differently, but with the same fatal flaws.

Unfortunately, this is a long-running shell game that individual investors have to be cautious of.

When I am asked to review these schemes, I no longer take much time trying to figure them out. Instead, I tell my clients to demand from the promoters an IRS Private Letter Ruling that complies in every respect with the mechanics of the plan being sold. If the promoters are unable to produce such a letter, I recommend against purchasing the plan.

LONG-TERM CARE INSURANCE

One of my previous *AAII Journal* columns, entitled "A Reality Check: Do You Need to Buy Long-Term Care Insurance?" appeared in the November 1997 issue and discussed long-term care insurance. One of the points raised in the article concerned pricing variability. Long-term care pricing isn't guaranteed, and I stated that it would very likely rise—primarily because competitive pressures had enticed most companies to price it to sell without really understanding the underlying factors that contribute to its cost. I also stated that human behavior would be greatly influenced by long-term care insurance coverage—maladies that older folks have put up with for years would become triggering events for filing long-term care insurance claims, substantially increasing claims.

Several weeks after that column was published, I received a call from an actuary who had recently worked on the pricing and design of a long-term care policy, and he assured me that my concerns about long-term care pricing were totally accurate because there is minimal long-term care claims experience to draw on.

During 1999, it became evident that many long-term care policies were terribly underpriced as renewal rates soared, causing a good number of lawsuits, attempts by California to legislate rate caps, and special attention from the National Association of Insurance Commissioners for creating price stability standards with model regulations.

An issue that hasn't received the attention it deserves is the absence of any long-term care policy value in the event it lapses. Several actuaries I talked with confirm that long-term care policy pricing uses lapse-support. This means that the profits from policy lapses are considered in overall pricing. (Profits in the sense that reserves have been accumulated for the payment of possible claims in the future, but policy lapses eliminate the future liability.) Receiving no value from a lapsed long-term care policy, perhaps after paying many years of premiums, is not fair. In addition, companies profiting from policy lapses could be found on a slippery slope if unethical companies were to shrewdly enhance their policy lapse rates by causing non-guaranteed elements of their policies to become uncompetitive, thereby chasing away policy owners. Long-term care policy designs should allow for a build-up in long-term care policy values, either in the form of a cash value or reduced paid-up long-term care benefits in the event a policy lapses.

Unlike life insurance, whose one-time triggering event is certain, a long-term care policy may pay benefits for a long period of time based on criteria that is somewhat subjective. This, combined with significant premium pricing uncertainty, means the choice of a long-term care company should be based on its record for fair policy owner treatment (in life insurance, since long-term care insurance hasn't been around enough to have a track record), rather than selecting a company based simply on the best price. With this in mind, I often suggest that individuals consider the option of purchasing the most expensive long-term care policy available from a company with unquestioned integrity [Northwestern Mutual Life], because of probable excellent claims payment experience, and because there is less likelihood that shocking premium increases will occur (and there is even the possibility of premium decreases). More competitively priced long-term care policies should be considered while keeping in mind the caveats expressed here.

Individual investors with sufficient assets to easily cover possible long-term care costs should consider self-insuring, and perhaps buying life insurance to reimburse their estates for possible long-term care costs because of the much greater certainty of the costs of life insurance. Only investors whose assets can't easily handle possible long-term care costs should be in the market to buy long-term care insurance with low expectations regarding its costs in the future.

LIFE INSURANCE LAPSE TRAP

In August I received a call from financial columnist Jane Bryant Quinn about a distraught reader, Mrs. Howard, who had recently been notified via a 1099 distribution form from her insurance company that she must include $47,000 in her income. This shocking fact, Mrs. Howard quickly discovered, was due to the inadvertent lapse of her permanent life insurance policy due to a zero cash value balance. The zero balance was the result of Mrs. Howard having taken a cash loan some years ago, then taking loans for the payment of premiums and further loans for compounding loan interest payments. The policy lapse transaction featured the inclusion of $47,000 in Mrs. Howard's income and a zero cash balance from which to pay taxes of some $16,000. This is referred to as phantom income.

Mrs. Howard was livid because the insurance agent had encouraged her to take the large cash loan and never indicated anything was amiss with her continuing to take loans to pay premiums. And while the insurance company did send her notices encouraging her to repay the loan because of the positive affects it would have on the policy, no one cautioned or even mentioned the possibility that the policy could collapse under the weight of the loans and cause her to pay substantial taxes. Mrs. Howard was further infuriated because two attorneys she contacted after receiving the 1099 form had no idea such a situation could occur, convincing her that she was the victim of some awful conspiracy.

Mrs. Howard hoped that her ignorance of the tax law and the failure of those in possession of such knowledge to properly inform her of the looming danger might let her off the hook with the IRS or provide grounds to sue the agent and insurance company. As to the former, the IRS doesn't allow unfamiliarity with the law to avoid taxes due. As to the latter, I advised her that such a suit would be a waste of time and more expense.

I contacted the insurance company for Ms. Quinn to obtain a schedule of the minimum costs to reinstate the policy and keep it going so Mrs. Howard could avoid being charged with this taxable income. This year's cost is $3,700 with subsequent annual costs ranging from $1,500 to $2,500 annually and dropping death benefits. I compared the $16,000 current tax bill to the present value for the minimum policy costs and determined that in 10 years the two figures are equal. However, delaying the policy's lapse only causes the amount of taxable income to increase. The current taxable income of $47,000 is nearly half what it increases to in 10 years when it is $95,000.

One additional factor I considered was the health of the insured. If the insured were in poor health, continuing the policy would be the prudent thing to do, because if death occurred, not only is the beneficiary entitled to the proceeds, but they are income tax-free. In this case the insured (Mrs. Howard's ex-husband) was in excellent health, so there is little probability he will die while the policy is being sustained with minimum premiums. Unfortunately, Mrs. Howard is retired and has just enough income for her routine needs with no cushion for this totally unexpected disaster.

Of course the insurance company considers its actions to be honorable. They are just following the law, and they sent out the notices asking for loan repayment to better enhance the value of the policy. However, the insurance company did fail this and other policy owners by not early, often, and explicitly warning Mrs. Howard of the tax consequences if her policy lapsed. Hopefully, Mrs. Howard's plight will serve as a rescue beacon to others who are blindly headed for the same disaster.

I am particularly concerned about the many investors who have purchased life insurance for retirement and are taking large policy loans as retirement income as recommended by their salesmen. These policies are not being managed, and some will end up terminating due to the massive loans, causing policy owners to include in income all of the deferred gain with no current policy value from which to pay the taxes. Be forewarned. ✥