

Economics For The Elderly: New Business Products And Options

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ABSTRACT

In this paper, we examine three types of money management tools that could be used in estate and financial planning matters. The first two, the life settlement, which enables the sale of life insurance policies in secondary markets, and the reverse mortgage, which is a loan taken out against the home equity accumulated and requires no repayment as long as the homeowner lives in the home, have been used as investment vehicles by insurance companies, banks, hedge funds, and other investment entities. The third tool, the power of appointment, provides counsel on the proper format for preparing the deed to minimize the tax implications related to the transfer of assets from the parent to the heirs.

Keywords: Life Settlements, Reverse Mortgages, Power of Appointment

INTRODUCTION

The aging population is faced with many dilemmas, including how and when to dispose of their assets. This is particularly critical if health problems force them into nursing home facilities, and the need for Medicaid assistance arises. In such a case, they would be stripped of the property they had accumulated during their lifetime. On the other hand, if they live long and relatively free of medical problems, the question arises as to whether they would be able to continue to enjoy the quality of life to which they were accustomed, which of course, would require money in hand. This paper highlights two new products on the market, as well as, a new use of a deed in preparing for the inevitable.

LIFE SETTLEMENTS

One radical thought is that a good, quick, safe, and guaranteed investment would be to obtain life insurance policies on all of the inhabitants of a nursing home since sooner rather than later, they will all die. This may sound “sick”. It is, and further, this could not be legally accomplished because the potential beneficiary would not have an insurable interest (ownership/property right) in the parties being insured.

However, life settlements now exist, and they have become a relatively new commodity that provides financing for seniors who hold life insurance policies on which they want to collect. This may be due to any number of reasons including the need for quick cash, increased premiums that the insured can no longer afford, or the death of the planned beneficiary. It has been estimated that more than 70% of life insurance policies, including group and secondary-market policies, lapse for nonpayment because they no longer meet any pressing estate planning or business planning needs (Breus, 2008). According to Stone and Zizzu (2007), there are other reasons why people choose to sell their life insurance policies. The insured may have no heirs, or may have very wealthy heirs in which case, he may be willing to trade his current wealth for future wealth at a lower rate.

A life settlement is the sale of an existing life insurance policy by the policyholder to a third party. The insured receives proceeds from the sale of the policy, which are higher than the cash surrender value (about 3-5% of the face value), but lower than the actual death benefit amount.

Life settlements have given rise to a growing secondary market that the elderly or terminally-ill, with changing circumstances, can exploit and use as an alternative to surrendering policies or letting them lapse because of nonpayment. According to the Life Insurance Settlement Association (LISA), data collected from 11 life settlement providers during 2004 indicate that they settled over 1400 policies with total death benefits of \$2.8 billion, with seniors collecting payouts of about \$1 billion from life settlements. On average, this amounted to 371.4% more than the cash surrender value of the policies. The growth of the life settlement market has been phenomenal. By 2005, estimates of the value of policies being traded range from between \$10 billion and \$20 billion. The major entities/investors that purchase the policies are investment bankers such as Credit Suisse Bank, Goldman Sachs, UBS AG, and Deutsche Bank, mutual funds, and hedge funds. The settlement providers provide a pivotal role in the transactions (Seitel 2007), and operate as middlemen, in the secondary market supply chain, who purchase the contracts and pay the policyholder on behalf of the investors.

The insurance industry has historically made a tremendous amount of money on life insurance policies which have become invalid or which were surrendered by policyholders. In many cases, a life insurance policy is taken out to provide support for the children in the event of the parents' untimely deaths. The insured wants to make certain that his family can survive without him. In other cases, these policies are purchased to provide funding during the college years of the children. However, the premiums usually increase with the increase in age of the insured, and conversely, the need for the insurance may decrease as the children complete their college education. The result is that there is an overwhelming number of insured policyholders, either surrendering the policy or allowing the policy to lapse, thereby receiving nothing from the insurance companies.

In summary, some of the circumstances that affect policyholders' continued payments of their life insurance premiums may be due to life changes that seniors face including:

- reduced income resulting from retirement, the loss of a job, or the death of a provider;
- increased premiums that they can no longer afford to pay;
- the irrelevance of the need for which the policy was originally purchased; and
- health problems, e.g., Alzheimer's Disease and other debilitating ailments that afflict the elderly and may cause them to neglect to pay their premiums on time.

These factors provide justification for the insurance companies to invalidate the life insurance policies, with policyholders receiving little or nothing in return after paying insurance premiums for years during which time they would have built up vast cash value on their policies from these payments. Life settlements provide a means for the policyholder to sell a portion or the entire life insurance contract to a purchasing entity and use the proceeds to pay monthly bills as well as for other necessities.

In Grisby v. Russell (1911) 22 U.S. 149¹ the Supreme Court of the United States considered the argument that an assignment of a life insurance policy to a person having no interest in that person is nothing more than a pure wager, which gives the assignee an interest in the insured's early demise. Despite this argument, the Court held that the assignee of the policy was not only entitled to reimbursement of the premiums paid by it, but further, entitled to the entire face value of the policy of insurance.

The companies purchasing the policies are looking for still another way to diversify. Through actuarial tables, they compute the policyholder's life expectancy and make an offer based on the same. They in turn, become the assigned beneficiary and pay the premiums on the insurance policy to keep it in effect. Obviously, the sooner the policyholder dies, the more profitable it is for the company. It is a wonderful business relationship, wherein the company is wishing the insured individual a speedy demise.

Almost every type of life insurance policy can qualify as a life settlement, and they include: whole life, universal life, and term life insurance policies (the term 'if convertible and assignable' applies). The requirements for eligibility mandate the insured to be at least 65 years of age, unless the insured's life expectancy has been shortened by virtue of poor health. The minimum face value of the policy must be \$250,000.00 and can be as much as \$100,000,000.00. There is a two-year contestability time period, which has to be satisfied. In addition, the

underwriting carrier of the insurance policy must have a high rating and the insured should have a life expectancy ranging from 25 months to 20 years.

Different states regulate life settlements differently and the insured could actually put out his or her policy for bidding. This competitive aspect enables the policyholder to obtain the most attractive settlement policy since several entities would then vie for the opportunity to take over his policy. The winning bidder continues to pay the premium, and in exchange, the original policyholder receives a lump sum payout.

A typical example of the amount that seniors could anticipate receiving from a transaction involving a life settlement is that of a male aged 70, with a \$2,500,000.00 term policy, with no cash value, for which he pays \$28,000.00 a year in premiums. He could sell the policy and receive \$411,000.00. People are generally unaware of this option, and with no cash surrender value, they would typically let the policy lapse when faced with increased premiums.

REVERSE MORTGAGES

Reverse mortgages are not recommended if parents want to leave their children substantial inheritances. Unlike almost every other loan, a reverse mortgage requires no income or employment qualifications; possibly a few credit requirements only. This makes sense, because with this loan no repayments are required. To qualify for a reverse mortgage, the individual must be at least 62 years of age, own his principal residence (a 1- to 4-family house, condominium or townhouse) and have equity in the property.

On the other hand, if the homeowner wants to continue living in his home, and in the style to which he is accustomed, this could be a solution. Simply put, the reverse mortgage is a loan that allows homeowners to cash in on the accumulated equity in their homes, receiving lump sum or periodic payments, while retaining ownership in the home. The lender computes the homeowner's life expectancy, factors in the equity in the home, and determines the lump sum payment, or a line of credit, or monthly payments to the homeowner over the his lifetime. The homeowner receives the money and does not pay back any principal or interest as long as he resides in this principal residence. However, when the homeowner dies and the home is sold, or if he sells the home, or if he does not occupy the premises for 12 months, then the loan must be repaid. If he lives the anticipated amount of time, there could very possibly be nothing left for his beneficiaries once the bank is paid, obviously depending on the amount borrowed, and the increased value of the home over time.

A typical situation for a reverse mortgage would be a homeowner (aged 72) whose pension/social security benefits were insufficient to keep pace with the mortgage, real estate taxes, household expenses, etc. The homeowner's house value is \$375,000.00 and he is currently carrying a \$100,000.00 mortgage, paying \$665.00 a month. With a reverse mortgage, the \$100,000.00 mortgage would be paid off and he could receive either \$125,000.00 in cash, or instead, \$741.00 per month for life. This example demonstrates how the homeowner benefits, by not having to pay the \$665.00 a month plus receiving \$741.00 per month, for a total additional cash in hand of \$1,406.00 each month.

In the example above, the Federal Government insures the loan, and the homeowner will never owe more than the property value, even if he outlives the equity. The FHA insurance provides protection to the homeowner and his heirs against that possibility. Further, the reverse mortgage money received will not affect the Medicare, Social Security and/or pension benefits. However, the closing costs could exceed \$15,000.00 for the above loan, with the lending bank and FHA charging over \$12,000.00 in fees, and this of course, is a downside to this type of arrangement.

POWER OF APPOINTMENT

Once again, the major asset of most elderly people is the family home. The "Power of Appointment" attempts to preserve this asset. A simple deed transferring the house to the children can accomplish this objective, and further, will start the clock running for the Medicaid "look-back" period. However, several other issues also arise including:

- capital gains tax to the children;
- possible gift tax to the parent – the grantor;
- the use of the \$1million lifetime gift exemption; and
- the basis for the children upon a sale of the home.

The Power of Appointment is a unique tool that can be used in preparing a deed to obtain favorable results to generally all of the above concerns. First of all, the Medicaid look-back period is accomplished by virtue of the deed with or without the power of appointment. Simply put, if the transferors (grantors) of the deed give their home away more than five (5) years before they apply for Medicaid, the property will not be considered an asset whereby the government can claim the same to offset the benefits being furnished to them through Medicaid.

Secondly, in regards to the capital gains tax, if the property is extremely expensive, a regular deed without the power of appointment might not be satisfactory. If the homeowner gives the property to his children as a gift (without consideration), the children get the basis of the parent. Thus, if the parent purchased the property in 1974 for \$150,000.00 and in 2008 the property is worth \$1.7 million, when the children sell the property, they will have to pay capital gains on \$1,550,000.00 million. Based upon the current rate of 15%, the tax would be \$232,500.00. Further, the parent would have to pay a gift tax on the amount over the \$1 million (\$700,000), because it exceeded the lifetime gift exemption.

Thirdly, the power of appointment transfers the property to the children; however, it reserves a right to the parent to change his mind. Hence, it is not a completed gift pursuant to Treasury Regulations Section 25.2511-2 (c)², and therefore there is no gift tax involved in the arrangement. However, it is considered a transfer for Medicaid purposes. Also, since it is an uncompleted gift, the home remains the property of the parent upon his death (Internal Reserve Code Section 2038 and 1014 (b)(a)).^{3,4}

When the parent passes away, if the estate is less than \$2 million, there would be no federal estate tax due (possibly state tax but usually at a lower rate) and the children would then receive the property with a \$1.7 million stepped-up basis. Hence, there is a tremendous savings in capital gains taxes.

On order to reduce tax liability, the language to be inserted into the deed to create the power of appointment should be as follows:

“And Grantor reserves the power to appoint, in whole or in part the property conveyed hereunder to or for the benefit of any one or more of the Grantor’s issue in such proportions, outright or upon such trusts, terms and conditions as the Grantor may specify by a writing executed and acknowledged during her lifetime and recorded in the _____ County Registry of Deeds within sixty (60) days of the date of such exercise, or by her last Will or Codicil making specific reference hereto. In the latter case, failure to record notice or any such exercise of this power in the _____ County Registry of Deeds within sixty (60) days of the Grantor’s death shall be conclusively treated as a default in the exercise of the power. A release of the power reserved hereunder, in whole or in part, shall be effective when recorded with the _____ County Registry of Deeds. Any exercise or release of the foregoing powers may be made by the Grantor’s attorney-in-fact acting under a durable power of attorney.”

The products and power of appointment set forth may vary from state to state, but could be useful in planning one’s estate for tax purposes, Medicaid purposes, and for simply having assets available to survive in the later years of life.

SUMMARY AND CONCLUSION

In this paper, we examine three types of money management tools that could be used in estate and financial planning matters. The first two, the life settlement, which enables the sale of life insurance policies in secondary markets, and the reverse mortgage, which is a loan taken out against the home equity accumulated and requires no repayment as long as the homeowner lives in the home, have been used as investment vehicles by insurance companies, banks, hedge funds, and other investment entities. The third tool, the power of appointment, provides

counsel on the proper format for preparing the deed to minimize the tax implications related to the transfer of assets from the parent to the heirs.

As the nation experiences a growth in its aging population, the opportunities for CPAs to give advice and recommendations to clients are vast. CPAs are in a unique position to capitalize on the opportunities accessible to them, and inform their older adult clients of the different options available to enhance their well-being, as they make their personal financial and estate planning decisions, as well as the decisions to maintain the quality of life and the dignity to which they have become accustomed. Senior citizens would then be secure in the knowledge that the wealth that they have built up during their lifetime would not be jeopardized, and that future generations would be able to benefit from the income that it could generate.

AUTHOR INFORMATION

Steven L. Kroleski, J.D. received his graduate degree from St. John’s University School of Law in 1975 and began his law career in New York City with the law firm of Milbank, Tweed, Hadley, and McCloy. He began his teaching career at Iona College, New Rochelle, New York in 1981, and is an Assistant Professor of Business and Environmental Law. Prof. Kroleski also has a private law practice in Westchester, New York, where he specializes in Business, Trusts and Estates, Real Estate, and Matrimonial Law.

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FOOTNOTES

1. Grisby v. Russell (1911) 22 U.S. 149.
2. Treasury Regulations 25.2511(2)(c)
(c) A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.
3. Internal Revenue Code Sec. 2038, Revocable Transfers
(a) In general
The value of the gross estate shall include the value of all property:
 1. Transfers after June 22, 1936
To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.
 2. Transfers on or before June 22, 1936
To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3 year period ending on the date of the decedent's death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.
(b) Date of exercise of power
For purposes of this section, power to alter, amend, revoke, or terminate shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, revocation, or termination takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purpose, if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.
4. Internal Revenue Code 1014 (b)(a).