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Subject: Thomas B. Strauchon - Life Insurance and the Highly Liquid, Ultra-High Net Worth Client, Why and Where It Fits

"Not every Ultra-High Net Worth ('UHNW') estate has a need for life insurance, regardless of the size of the taxable estate or the corresponding amount of the estate tax liability. This is especially true if the estate is highly liquid and the primary objective is not wealth preservation. In fact, the UHNW client may not need any life insurance at all if the estate executor can gather sufficient funds from cash plus proceeds from the sale of marketable securities to meet the tax liability. In this case, there arguably is no need for any life insurance. That said, there are a number of reasons why the UHNW client may choose to use life insurance. One primary reason is as a 'hedging' strategy."

Thomas B. Strauchon, CFP® provides members with commentary that examines the use of life insurance and the ultra-high net worth client.

Thomas B. Strauchon, CFP®, a 39-year industry veteran**,** is **President** of **Strauchon & Company LLC**, a life insurance consulting firm that works with HNW and UHNW clients and their advisors on the sophisticated applications of life insurance in business succession and estate planning for HNW and UHNW clients, many of whom identify as family-owned businesses. Tom also serves as **Managing Director of Life Insurance Services** for **Long Road Risk Management LLC**, which works with RIA's and other advisory firms on life insurance matters. Tom started in the industry in 1981, with a Cleveland-based firm that utilized fee-based planning for successful closely-held businesses, and life insurance as one of a number of tools in the tool-box. In 1991,Tom founded Family Business Planning Group, Inc., a Cleveland, Ohio based boutique fee-based planning firm. In 1992, Tom founded The Family Business Presidents' Council, which consisted of, at its peak, 4 groups of 10 members each, with monthly roundtable meetings providing a forum for family business owners to share common issues, problems and opportunities. In 2003,Tom merged his practice in with the wealth management firm, Sequoia Financial Group, LLC, where he served as VP of Life Insurance through January of 2018. Tom worked closely with the

wealth planning team at Sequoia, along with members of the tax department of Cohen & Company, a Cleveland-based regional accounting firm, which together with Sequoia represents a very successful Multiple Disciplinary Practice (MDP). In February of 2018, he founded Strauchon & Company, LLC.

Here is his commentary:

EXECUTIVE SUMMARY:

Not every Ultra-High Net Worth ("UHNW") estate has a need for life insurance, regardless of the size of the taxable estate or the corresponding amount of the estate tax liability. This is especially true if the estate is highly liquid and the primary objective is *not* wealth preservation. In fact, the UHNW client may not need any life insurance at all if the estate executor can gather sufficient funds from cash plus proceeds from the sale of marketable securities to meet the tax liability. In this case, there arguably is no *need* for *any* life insurance. That said, there are a number of reasons why the UHNW client may *choose* to use life insurance. One primary reason is as a 'hedging' strategy.

COMMENT:

At the core of this premise is the fact that in many cases, state of the art life insurance design delivers investment-grade returns of death benefit on invested premiums at life expectancy. To give this even further definition, some policies deliver very attractive internal rates of return (IRR), often on a "fully guaranteed" basis.

IRR is a time-weighted measure of the average annual return received in the future, on a lump-sum or, more typically, a serial investment program (think of annual contributions to a retirement program, or premium payments to a life insurance program).

So what would the UHNW client be hedging?

Economic downturns, for one. Think 2008-2009 when equity markets cratered 35% or more (and, in a once-in-a generation event, bonds and credit markets cratered, too). Think 2000 and the tech bubble that went

‘pop.’ Think of the so-called ‘lost decade’ of 2000 thru 2009 when the S&P 500 was essentially flat.   Fill in your own time period of financial peril.

Savvy UHNW investors, during such times of financial turmoil, may have felt some short-term discomfort. But upon reflection, and perhaps after consultation with financial advisors, they reviewed and adjusted the portfolio asset allocation, perhaps harvested some losses to offset any gains, but largely didn’t liquidate any ‘paper losses’ in the portfolio. They did this because they know that in the long haul, the market will recover. The market always comes back. UHNW estates often have a very long, multi-generational perspective.   Market downturns, to the sophisticated, long-term-focused investor are an inconvenient bump in the road. Paper losses generally remain just that.

But what if, in the middle of a market pullback, or even a full-blown recession, the unthinkable occurs: The death of the 2nd to die of the senior generation. The event is inevitable. It’s the timing that’s the great unknown. A very large tax bill is due and payable within 9 months. And, what if the only resources available to pay the bill are cash and proceeds from the sale of marketable securities and/or other assets?

The answer is: Then _paper losses_ become _real losses_….the permanent kind. It happens.

An UHNW family may decide that this is an acceptable risk. And while, it may make for some uncomfortable quiet reflection, and perhaps some second guessing from certain family constituencies as cash and balance sheet values decline when the tax bill is paid, in the end the kids and grandkids are not going to be out on the streets. Lifestyles probably will not change substantially. Any negative consequences are likely to last for a relatively short period of time from a multi-generational perspective.

But here’s the question: If a hedging strategy exists that could mitigate, or perhaps prevent such economic misfortune and the related histrionics altogether, and that strategy is one that is _accretive_ to overall estate value (and not an expense per se), why would highly sophisticated UHNW families not implement the strategy?

The answer may be because no one told them the rest of the story about life insurance. The part about the economic return.

Frequently, if not usually, discussions about or consideration of life insurance are framed in terms of the premium. It is viewed as an expense, not as a financial instrument with an economic return. This view is statistically appropriate for most term life insurance, given the low percentage of policies that ever result in death benefits being paid. Term insurance is appropriate to cover a contingency: *what if I die during a specified period of time?*

But, for 'permanent' coverage, secured not to cover a contingency but a certainty (*when I die*), a return on the invested premiums should be an expectation.

UHNW clients are sophisticated. They don't 'buy' investments as much as they invest in opportunities, many of which are expected to be realized sometime in the future.

Strategically designed life insurance is a lot like that, too. It's an investment for the future. One important distinction is that the benefit is for someone else. But for UHNW families, a meaningful portion of the estate's portfolio of the estate *are* legacy assets, which are ultimately for the benefit of someone else anyway. Life insurance is the asset class that can help protect the erosion of the value of other legacy assets in the estate, while providing a solid financial return of its own.

The potential uses of life insurance for estate and wealth transfer / wealth preservation planning of UHNW clients actually goes well beyond just hedging market downturns. The following is a partial list of less-than-desirable outcomes that can potentially be mitigated:

Life Insurance Helps to Hedge Against:

- **Incomplete wealth transfer strategies (GRAT's, IDGT sales, other non-completed gifts**). Many leveraged, and potentially highly effective wealth transfer strategies require time and/or successful market outcomes of the underlying assets. These techniques often work very well. Untimely, unpredictable events can play havoc with the financial outcomes, though. They don't always work, or work as well as had been intended. Ask a member of your planning team if

they've ever had to 're-GRAT' an asset for a client. It's not uncommon.

- **Changing tax environment: Income, capital gains and estate taxes**. Tax rates don't always go down. Exemptions don't always go up. The past 30 years or more is ample proof of this reality. The more recent trend for tax rates and exemptions has been, for the most part, encouraging. Changing of the guard in Washington, which does happen every 4-8 years, can bring a complete overhaul, no change or anything in between. As a wise and experienced practitioner said many years ago, "tell me the tax environment in effect when you die, and I'll tell you whether the planning you did will work out." But since Nostradamus is likely not a part of your planning team, doesn't it make sense to hedge the bet?

- **Changing liquidity profile of the estate**. Gen 2, or maybe Gen 3 decides to pursue an entrepreneurial opportunity that reduces the amount of liquidity. It happens.

- **Generational dilution of wealth**. Over time, the amount of assets per family dilutes even without consideration of the erosion of value due to taxes. At every generational divide, as the wealth of two gets divided by a larger denominator (the number of children and/or grandchildren, for example), dilution occurs. It's simple math. Many clients are OK with this outcome. Again, nobody is in financial peril. But, if there was a way to mitigate this outcome, and provide a ready source of fresh liquidity, what opportunities might be realizable?

- **Disallowed entity or asset discounts**. Your estate planning team told you to expect a 40% discount, but the IRS either disallows the discount entirely, or allows a smaller discount than originally anticipated. Some valuation experts are conservative. Some are aggressive. The IRS focuses on these strategies in the estates of the UHNW. Ask the valuation expert who opined on the discount for highly leveraged wealth transfer strategies in your estate, that may have included, for example, minority interest entity-level discounts, for examples of *disallowed* discounts. They are the stuff of estate planning conference case studies.

- The potential for a future declination in health. The sudden onset of a medical development, such as sleep apnea, diabetes, cancer or a cardio-vascular condition can make it impossible, or at least much more expensive, to obtain life insurance once discovered, not to mention the shortening of life expectancy. "You're never going to be younger or, quite likely, healthier than you are today," is a seemingly obvious bit of advice I've given many clients over the years.

In addition, life insurance is a financial tool that is very supportive of the following estate and/or business succession strategies:

- **Basis step-up for 'retained' low basis assets**: Low basis assets, such as closely-held interests or real estate, can get a step-up in basis if they remain in the taxable estate, as opposed to being transferred through leveraged gift and transfer strategies and techniques, where the original basis is transferred along with the asset. Life insurance used to pay the tax associated with retaining assets in the estate mitigates the estate tax component of the transaction, and allows the junior generation to enjoy a freshly depreciable asset, or to sell the underlying asset with little or no capital gains exposure (depending upon when the sale occurs). The *net to heirs after all taxes* (estate and capital gains, for example) can be significantly enhanced.

- **Equalization**: Think of a closely-held business interest in which 2 children earn their living, but a third has no active involvement. Two have 'invested careers', while one has a source of potential income, when distributions exist. Two think about growing the business, whereas the third looks for supplemental income. It can be a source of great conflict within a family. Many families have suffered irreparable relationship damage over just this kind of squabble. Life insurance creates value that can be used to 'equalize' or 'make equitable' a distribution of cash that can be invested as the heir sees fit, while an asset better owned by those who have an active, working involvement in the enterprise have complete control over that asset.

- **Asset creation for non-bloodline family members**: Think of the in-law, whose spouse is the heir of a dynastic trust. In the event of the death of the bloodline heir, the widowed spouse could suddenly be without an income source. Life insurance can create the capital to

provide a lifetime income so that the 'in-law' doesn't feel like an 'out-law.'

- **<u>Liquid Asset Creation</u>**: *"What creative uses might there be for an infusion of $10,000,000 of fresh capital in the future"?* This, of course, is a rhetorical question. The uses can be controlled by terms and conditions in a Dynastic Trust, restricting utilization to supporting, for example, entrepreneurial start-ups, expansion of an existing family business, educational or even charitable interests of future generations. A wise and very experienced estate planner told me years ago that there is no asset as valuable as cash in an estate, from the perspective of the executor. "It provides options," he explained. "And options are *always* good."

Life insurance is a very unique financial instrument. The death benefit component has no positive correlation to any other asset class in an estate. Thus, for diversification and asset allocation considerations alone, it can often earn a place at the asset allocation & planning table for families with a multi-generational perspective.

Tom Love, CLU, FLMI, Vice President of Insurance Analytics for Valmark Financial Group, has worked with many family offices and UHNW families puts it this way:

> Life insurance empowers thoughtful decision making regarding asset utilization, both during life and at time of death. Maybe you can invest in a less liquid opportunity that arises because you have a life insurance liquidity backstop. Maybe the executor has more strategic choice in which assets to liquidate and when to meet tax obligations. Why not give your family choices rather than subjecting them to edicts from the tax regime du jour?

Larry Rybka, JD, President & CEO of Valmark Financial Group, and a recognized life insurance industry leader adds:

> One of the things the life settlement partnerships are promoting to their investors is that life insurance is completely uncorrelated to any other asset class. If corporations, banks and settlement funds are buying policies for the pure economics, trustees should consider it as well.

So, while there may be, arguably, no *need* for life insurance in the estate plans of the highly liquid UHNW family, there are characteristics and benefits of the financial instrument which probably merit consideration by many. It's simply another financial tool that can add great value in the right context.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Thomas B. Strauchon

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