

What Accountants Should Know about Life Insurance Policy Evaluations

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As accountants pay increased attention to evaluating the performance of a client's life insurance portfolio, life insurance is becoming recognized as a "buy and manage" asset rather than as a "buy and hold" asset.

If an insured person's policy has insufficient cash value, it will cause their life insurance coverage to expire prematurely. However in some situations the insured may have more cash value than is actually needed. Let's take a look at the role too much or too little cash value plays in a client's life insurance portfolio.

Today as more and more individuals become aware of the importance of evaluating the performance of their life insurance portfolio, they are realizing that life insurance is an asset that must be actively managed in the same manner as they would evaluate the performance of their stock and bond or real estate portfolio.

Many owners of life insurance policies have found that if they purchased life insurance between 1983 and 2003, there was a high chance that the contract was of a nonguaranteed nature. In other words, the duration of coverage was entirely dependent on the amount of premium paid and the performance of the interest rate earned by the life insurance company.

The mere fact that a person paid the originally billed premium was not enough to guarantee that the coverage would be there, at the insured's death. In the early 1980s, when interest rates were much higher, many owners of these nonguaranteed contracts mistakenly assumed that interest rates would always remain as high as they were then. In many cases they incorrectly used those higher interest rate assumptions to calculate what their premium would be going forward. However, as rates continuously declined over the last 25 years, the average interest rate was significantly lower than what they anticipated.

Subsequently, as a result of their not adjusting their premium upwards and paying a higher premium to make up for the reduced interest rate earnings, approximately a quarter of the owners of these nonguaranteed policies have since found that their life insurance coverage is expiring years earlier than anticipated. Such are the consequences of sustained reduced interest rates, coupled with years of inattention by the grantor and the accommodation trustees, usually the grantor's eldest child.

As a result many trust beneficiaries and their families are left without the life insurance estate they were otherwise expecting to receive.

Some of those beneficiaries are now litigating against their trustees, and their advisors. In one recent case in Nebraska, *Rafert v Meyer*, the beneficiaries sued the trustee for not having paid the life insurance premiums and the life policy lapsed. The trustee thought he was protected from any liability as a result of the trust's exculpatory clause.

In many cases the economics that the grantor must decide are whether it makes sense to continue their coverage, protect what has already been paid, and weigh that against how much more will have to be paid to keep the coverage in force so that it lasts for the grantor's life expectancy. Oftentimes this can entail a 100 to 200 percent increase in their current premium. The alternative is to give up (lapse) all or part of the coverage, and lose all of the premiums previously paid, if it's determined that the future premiums are too costly to maintain the policy.

Before you ever allow a client's life insurance policy to lapse without value, make certain your client is not subjecting themselves to a taxable event on any gains in the cash value over and above what they paid in premiums.

Secondly, have your client explore a "life settlement," a process of determining the price that a buyer in the secondary market would be willing to pay an insured to purchase their life insurance policy. If you as an accountant don't advise your client of the existence of a life settlement strategy, don't expect help from the rest of the financial community. Many career agents are forbidden to talk about this option as it prevents policies from lapsing, thereby reducing the profitability of the Insurance company.

An issue in a pending case in California, *Larry Grill et al v. Lincoln National Life Insurance Company*, involves the active concealment by an agent and a life Insurer of a life settlement option from a grantor.

So what's the best way for an accountant advising the son or daughter of a client acting as an accommodation trustee to protect them against a suit alleging they violated their fiduciary obligations? They first have to be informed that there may be a problem, as many individuals are not even aware that their life Insurance policies may not be guaranteed, and that a policy could expire prematurely.

If that's the case, Intervention is needed and the logical source is the policy owner's accountant and/or legal advisor working in conjunction with an experienced fee-based life insurance consultant to conduct an independent performance evaluation of their privately owned or trust-owned life insurance.

Engaging an experienced independent life insurance consultant is critical to making certain the policy does not lapse as a result of an inadequate premium. Doing so will also provide a dispute-defensible assertion to protect the trustee, which is especially important if the accountant is also acting as the trustee of a client's irrevocable life insurance trust.

There are also times when there may already be too much cash value in a life insurance policy. One such example involves an older gentleman with approximately \$500,000 of cash value and an annual premium of \$50,000. He had just been diagnosed with a terminal illness and had a two- to three-year life expectancy. Yet without any regard to the grantor's health, the trustee continued to pay the \$50,000 annual premium in each of the three years prior to his death. In such a situation a trustee could be held liable for wasting trust assets by having paid more premiums than was necessary.

An accountant who is familiar with the benefits of a performance evaluation of a client's life Insurance portfolio would have known that a "life expectancy" report would have been included in such an evaluation. That report would have commented on the current health status of the insured/grantor and would have informed the trustee that no additional premium payments should be made on this policy.

Many unskilled trustees would not recognize that a change in health is an opportunity to save premium dollars by discontinuing to make their premium payments. If a trustee doesn't have the necessary skills or expertise to properly evaluate the performance of a life insurance policy, he or she must obtain the expertise from outside sources.

The tools to provide various analytical cost-saving services are available. They just need to be understood and incorporated into an accountant's annual face-to-face meetings with clients. This is especially significant in today's tax climate where the income tax bill is on par with the estate tax considerations. As a result, it may at times make a great deal of sense to have clients accumulate excess cash on a tax-deferred basis to supplement their retirement income using the cash accumulation account of a personalized and diversified portfolio of life Insurance contracts.

This strategy of accumulation is normally followed by a series of tax-free distributions through loans during a client's retirement that never have to be paid back and will remain tax free as long as the underlying life Insurance policy does not lapse prior to the insured's passing. Keeping that nonguaranteed life insurance contract in force is essential regardless of which strategy an accountant may advise a client to choose.

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