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What Your Clients Wish You Told Them About the Life Insurance Funding Their Personal, Corporate Trusts and Business Agreements

By Henry Montag

Attorneys establish trusts and business agreements for their clients for a variety of reasons. Perhaps an irrevocable life insurance trust (ILIT), to provide liquidity for estate taxes. A grantor trust for a parent or grandparent wanting to provide family income, professional management, or guidance for an inheritance earmarked for the next generation. A special needs trust (SNT) to provide for the welfare of a child even after their parents are no longer here to take care of them. A buy-sell agreement to assure the orderly transfer or disposition of their business interest for the benefit of their family, and business partners. Since more than 90 percent of the Fortune 500 corporate clients have a deferred compensation plan (DCP) many of their small business owner clients have similarly requested to establish a deferred compensation plan to supplement their retirement income, or perhaps to allow a class of employees the ability to defer a portion of their income as a perk at their place of employment.

The Role of a Life Insurance Policy

What do all of these trusts and agreements have in common? There's a life insurance policy used to fund each of the situations mentioned above. It's therefore important for the grantor as well as the amateur trustee, usually the eldest sibling, to become more knowledgeable regarding their responsibilities associated with managing the various types of life insurance policies funding their trusts and agreements. The purpose of this article is to familiarize the reader with information that can be used to better understand the opportunities that exist, and identify the proper strategy required to provide guidance to your clients' children acting as "amateur trustees."

Trustees may have received very little guidance regarding the consequences of their actions and inactions when it comes to dealing with the current mismanagement of many of their existing life insurance portfolios. Life insurance has two purposes that can be used individually or combined:

1. To provide an immediate leveraged tax-free death benefit.
2. To provide a tax-deferred accumulation vehicle as an asset class.

Regardless of the use or purpose it's essential that a client understand that life insurance policies do not come with an automatic management function and that each of the policies funding their respective trusts and agreements requires an ongoing review process because personal events and economic situations can and do change. How would you as an amateur trustee or an advisor to an amateur trustee of an ILIT react to receiving a notice from the insurer stating that the $1,700,000 life insurance policy in the trust is going to lapse in the next 12 months unless a significantly higher premium is paid? The insured is age 81, in good health and so far has paid more than $400,000 in premium. Your action is needed immediately. What would you advise? The point is if you or your amateur trustee client do not have the necessary skills, it's your responsibility to retain the services of someone who does.

How Did That Happen?

All too often a person will accept the title of trustee but won't fully understand the ramifications, the responsibility, or the fiduciary liabilities that come along with that title. One of the prime responsibilities of a trustee using any type of a life insurance policy is to make certain that the policy will be in force when the grantor dies.

Let's look at a typical situation occurring today. In 1990-2000 if a client purchased a $1 million life policy it would have been suggested that the policy be owned by a trustee of an ILIT to keep the death benefit out of the grantor's taxable estate. In 10 percent of the situations the grantor would have chosen to use an institutional or corporate trustee. However, in the other 90 percent it was usually the grantor's eldest child that was made a trustee—a trustee that had the responsibility, but not the necessary knowledge, experience or guidance to properly manage the life insurance policy, to prevent it from expiring prematurely. Nor did the trustee realize that he or she assumed 100 percent of the performance risk for the life insurance policy that he or she didn't know was not guaranteed.

What Happened?

As a result of 25 years of reduced sustained interest rates and neglect on the part of the amateur trustee, usually an eldest child who wasn't aware that the life insur-

Henry Montag, an independent certified financial planner, has been in practice since 1976 with offices located on Long Island, NY. He is a principal of The TOLI Center East, providing independent consultative fee-based, individually or trust owned life insurance performance evaluations for high net worth clientele, their trustees, advisors and family offices.

ance premium he or she was paying should have been increased, the duration of the death benefit of that policy was shortened. The problem compounded itself over the years to the point where many 80-year-olds are now learning that their life insurance coverage is only going to last for a few more years unless a significantly higher premium is paid to make up the insufficiency created over the last 25 years.

How can that be, they ask? They've paid all premiums on time and never borrowed any cash value. What neither they nor their amateur trustees understand is that 45 percent of the life insurance contracts they and many others purchased over the last 25 years were universal life insurance policies that were not guaranteed to last for the rest of an individual's life. The duration of the policy was based on an anticipated interest rate in the 1980s that didn't materialize. This situation changed in 2003 when insurers began offering guaranteed universal life policies. The difference between a non-guaranteed universal and a guaranteed universal or a whole life policy is that the latter has a higher premium that's used to build up a sufficient amount of cash value designed to guarantee the policy will last for the rest of an individual's life.

However, insofar as any universal life policies purchased prior to 2003, it was the owner/trustees' responsibility to make certain that any shortfalls, between the assumed interest rate when the policy was first taken out and the actual interest rate that was credited to the policy in each of the last 20-30 years, be made up by increasing the premium paid to the insurer.

The Role of the Trustee

Unfortunately, neither most amateur trustees nor their advisers realized that a non-guaranteed life policy required this type of active management, and as a result 23 to 25 percent of these non-guaranteed universal life insurance policies are now expiring prematurely.[1] This situation has grown increasingly worse because just as people are living longer,[2] their non-guaranteed life policies are expiring earlier.

It's important for clients to understand that 45 percent of the current life insurance policies in force today are non-guaranteed life insurance policies. These policies require active management and the sooner they find out if they require adjustments the better it will be for them and their beneficiaries. Most life insurance policies, even whole life policies, require some form of active management and should be considered a "buy and manage" asset rather than the "buy and hold" asset they are often erroneously considered.

Once a problem is discovered, trustees and beneficiaries alike often begin looking at who is at fault and who can be blamed. "Isn't it the agents' responsibility to make sure I'm billed properly?" or "Shouldn't the insurance company have billed me correctly?"or "Shouldn't my attorney that drafted the trust or my CPA who is involved in all my financial decisions have advised or informed me?" Despite the fact that 90 percent of the trustees who serve in the capacity as an amateur trustee have no skills, and receive very little guidance when it comes to dealing with maintaining a non-guaranteed life insurance policy, the answer to all of the above questions is "no."

Neither the agent nor the company is responsible. It's the trustee who has 100 percent of the responsibility to manage the policy and only the owner/trustee can make a decision to increase or decrease the billed premium of the policy funding the trust.

Judicial Decisions

Going one step further, the courts in *UBS Financial Services Inc. v. Thompson* have held that the agent/broker has no post-sales responsibility at all.[3] It is solely up to the owner of the policy to make those management decisions. Further, in the absence of these management decisions, the court in *Rafter v. Meyer*[4] held that a trustee has a non-waivable duty to keep beneficiaries informed about the status of life insurance policies held in trusts for which they are trustees. The point, according to Steve Leimberg's executive summary, was that the trustee should treat a life insurance policy as it would any other trust asset.

In August 2012, the Office of the Comptroller of the Currency (OCC) issued revised guidelines that direct financial institutions serving as trustee of an insurance trust to treat life insurance as they would any other asset. This means life insurance, just like stocks, bonds and real estate, needs to be actively managed.

Providing a policy performance evaluation and then monitoring it every one to three years, depending upon product, would be a good idea for all amateur trustees. As would be the directive given to corporate trustees under the Uniform Prudent Investor Act (UPIA) that they treat life insurance as they would any other trust asset.

Impact of COIs

Why is all of this attention suddenly being paid to this topic? Very simply life insurance companies, more so than many other financial organizations, have been adversely affected by the sustained reduced interest rates and are currently seeking to do whatever they can to return to profitability. Unfortunately, the way they've chosen to respond has taken a toll on many families.

Please inform your clients that the life insurance company has no obligation to the insured or the beneficiaries. Clearly their obligation is to their stock or shareholders. When a life insurance policy lapses, it means the insurer gets to keep all of the premiums that were paid and will never have to pay out a death benefit. A very profitable situation for the insurers as, all they're required to do is send out the annual statements, which most people don't read, and by virtue of inertia individual life policies are expiring on their own. However, to make matters even better for the insurers and worse for their insureds, several years ago the *Wall Street Journal*[5] reported that insurer's began to exercise a right they've always considered as taboo, raising the internal cost of insurance (COI). An increasing number of insurance companies are now exercising their contractual right to increase the internal COI for the 45 percent of the existing non-guaranteed universal life insurance policies. This action, in addition to 25 years of reduced interest rates and neglect, has caused a perfect storm that is now further exacerbating an already deteriorating situation, causing more life policies to expire even sooner.

Do I Still Need That Policy?

Now that estate taxes have virtually been eliminated for much of the population, or at least put on hold till 2025, many of your clients are now pondering what to do with the life insurance they had previously purchased with the intent to pay their federal and state estate taxes. While that topic is a subject to be discussed in a separate article, the question for many becomes, "Should I continue to pay an increasing premium for insurance I may no longer need? Or should I give up my coverage? If I decide to give it up, exactly what should I do? Should I surrender the policy back to the insurer in exchange for the cash value? Should I merely reduce the death benefit and pay less premium?" Depending on an individual's health and age, a smarter but less well known option is an alternate exit strategy known as a "life settlement." This is a process where the insured sells all or a portion of their existing life insurance portfolio, just as they would a car or a house. Such a sale is transacted on the secondary market in which a hedge fund acts as a purchaser, and the seller usually receives a significantly higher payout than if they would have surrendered the policy back to the insurer.

Do I Need a Guarantee?

Going forward, today a client can obtain a guaranteed universal life insurance policy that can be designed to last for as long as they choose. Naturally the longer a person wishes to guarantee that their life policy will remain in force, the more it would cost and vice versa.

Guaranteed duration is especially important for a family setting up a special needs trust (SNT) when they want to make 100 percent certain that the life insurance policy they purchase remains in force for the duration of their lives to support their child after they're gone, or to provide an inheritance for their children.

Term or Permanent Life Insurance?

A buy-sell agreement between business partners can either be funded with a less expensive term life insurance policy, which is guaranteed to last anywhere from 5 to 30 years, or up to age 83, or it can be funded with a permanent life insurance policy that costs significantly more but lasts a lifetime because it builds up cash value. This cash value can later be used to supplement their retirement income. If a business is first starting out, or if cash flow is an issue, they should use a term policy to provide the maximum death benefit for the longest period of time, for the least amount of premium outlay. But if your client is involved in a well-established company where cash flow is plentiful, they may consider utilizing a permanent life insurance policy for its tax-deferred accumulation benefits which, in addition to providing life insurance, can later be used as an asset class to supplement their income at retirement.

Life Insurance as an Asset Class

Sometimes life insurance is not used for its death benefit, and is instead used for its favorable tax-deferred accumulation build-up and tax-free distributions. Such would be the case if a client involved in a C-corp decided to use life insurance as an asset class via a deferred compensation plan (DCP). In this manner a key employee or the owner of the business itself , depending on certain restrictions, can reduce their current income and place the reduced amount of salary in a life insurance policy with just enough life insurance to still be able to utilize the life insurance policy's tax-deferred accumulation status. Doing so would not only build up a tax deferred accumulation fund, but can also years later distribute the income from this cash value on a favorable income tax basis to supplement their otherwise taxable retirement income.

Mechanically, this can be done through the use of a series of withdrawals up to basis, and then loans that never have to be paid back as long as the death benefit survives the insured. A split dollar arrangement can also be used to make certain that the corporation gets back 100 percent of its initial outlay from the death benefit. A similar arrangement, called a supplemental executive retirement plan (SERP), may be used in an S-corp or LLC for an employer, based on various percentage ownership rules, or an employee, but only on an after tax basis.

To Clarify Matters

Recognizing that the often spoken about Fiduciary Rule is still not here, don't rely on that piece of legislation to protect your client. Although various states have taken the lead in attempting to protect the consumer from new purchases.[6] It's solely up to you, the one who drafted your client's documents and trusts, to protect your client's current life insurance portfolios. A useful tool I use in my practice to record all available options, including the life insurance, is a letter of intent statement (LOIS) where I have the grantor meet with the trustee on an informal basis to discuss in plain, simple language the grantor's intent and to assure the trustee's understanding of what needs to be done under various circumstances. I then turn this into an informal letter given to the trustee by the grantor. This letter along with an adequate funding statement (AFS) obtained from a client's CPA or retained independent life insurance consultant, is used to insure that the life insurance policy chosen is sufficiently funded to meet the grantor's objectives, and that they are periodically updated and reviewed to keep current with the grantor's wishes as to beneficiaries, duties and allocated percentage distributions.

In Summary

In summary, someone needs to advocate for the grantor's beneficiaries and coordinate all of the above to make certain that the next generation's future inheritance and well-being are not endangered as a result of outside economic conditions or neglect. There is perhaps no better way to meet and engage your next generation clients than to initiate a conversation with them regarding the consequences of the current mismanagement of their existing life insurance policies and to let them know that you're interested in discussing the best way for them to preserve the life insurance inheritance left by your client, their parents, for them and their kids. While it may be easier to draft an exculpatory clause in your trust than to provide guidance to an amateur trustee, the rewards of that guidance will be far greater and appreciated by your next generation client. The estate planning attorney is the logical choice as the professional advisor in the best position to arrange, invite, and manage such an initial meeting. The outcome of that meeting can generate additional appropriate options to enable the attorney to provide the amateur trustees with the guidance needed to maximize their life insurance premium dollars. It can also make certain that their individually owned or trust-owned life insurance policies funding their parents' or child's trust, or business partners agreements are updated and do not join the increasing ranks of life insurance policies expiring years earlier than anticipated.

Endnotes

1. The Life Insurance Policy Crisis, ABA Jan 2017.
2. Society of Actuaries Report, Nov. 2014.
3. *UBS Financial Services Inc. v. Thompson*, No 0352 (Court of Special Appeals of MD, June 25, 2014).
4. *Rafert v. Meyer*, 227 the Nebraska Supreme Court, 290 Neb 219.
5. Scism, Leslie, *Life Insurance Rates Are Going up for Many*, The Wall Street Journal, Dec. 5 2015.
6. Baldwin, Ben, *Between a Rock and a Hard Place*, CCH, April 2018.

Henry Montag

Henry Montag CFP, in practice since 1976 in L.I N.Y has authored articles and or provided CPE & CLE credits for the New York State Bar Association, NYSSCPA's Tax Stringer, Tax Facts, Trusts & Estate Magazine, & Accounting Today. He co-authored an American Bar Association Flagship publication "The Advisors & Trustees Guide to Managing Risk & Avoiding a Client Crisis" Jan 2017.

thetolicentereast.com

(516) 695-4662

henry@thetolicentereast.com