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Helping clients with trust-owned life insurance

By Henry Montag April 16, 2021

Accountants sometimes need to decide whether to accept the invitation to become a trustee of a client's trust-owned life insurance. If you do, how should you approach your fiduciary responsibility to ensure you do the best job for the grantor's beneficiaries, while avoiding any of the fiduciary liability that comes along with the title of trustee?

You may need to guide your client's designated trustees — often sons and daughters who act as unskilled trustees — to prevent the life insurance policies they're responsible for from expiring prematurely. As a result of the passage of the Uniform Prudent Investor Act, trustees today are held to a higher standard than ever before. Those practices under UPIA apply equally to life insurance as they would to any other asset class such as stocks, bonds and real estate portfolios.

About 50 to 60 percent of universal life insurance policies written over the last 25 years are in danger of expiring prematurely as a result of two factors: a significantly reduced and sustained interest rate environment over the last two decades, plus the neglect of unskilled trustees who weren't aware that life insurance required active management and that the premiums on their policies should have been increased to offset the reduced interest rates. This holds true regardless of whether the life insurance is owned individually or through a trust, as all non-guaranteed life contracts have been adversely affected equally.

Many accountants have suggested that their high-net-worth clients use an institutional trustee for their trust-owned life insurance policies, while others have chosen to serve as trustees of such trusts themselves. Since many institutional trustees charge a fee for their service, only about 10 percent of TOLI policies use a corporate or institutional trustee to professionally manage a client's irrevocable life insurance trust. These trustees, unlike their unskilled counterparts, actively manage the policies entrusted to them, as they are under the watchful eye of the Office of the Comptroller of the Currency, which monitors the trustees' activity.

The other 90 percent of TOLI policies are managed by the grantor's son or daughter, despite the fact that the vast majority of these unskilled trustees don't have the requisite skills or knowledge to manage the performance of a life insurance policy. Many unfortunately don't understand the basic problem that their life insurance policies are not guaranteed. If the policies are not actively managed just like their other asset classes, they and their families will suffer significant financial losses. Non-guaranteed life insurance coverage is expiring at an increasing rate, and the majority of these unskilled trustees are not aware they have assumed all performance risk and fiduciary responsibility and liability when they agreed to act as a trustee. Since most unskilled trustees aren't equipped to evaluate the risks, or monitor the performance, they are unlikely to do what is necessary to remediate the underlying life insurance policy to prevent it from expiring prematurely.

While the majority of life insurance policies purchased over the last two decades have typically been a flexible premium, non-guaranteed universal policy, the problem extends to variable and even whole life contracts that contain a blend of term insurance or are being paid for by borrowing from their cash value or relying on their dividends, which aren't guaranteed.

Beyond the original illustration

So how can the accountant, acting as trustee or advisor to the policy owner, know if the universal life policy they or their clients hold have problems? The original illustration is generally of no help since life insurance illustrations are simply computer printouts that show various aspects of the policy, premiums, cash values and death benefits under assumed interest crediting rates often made over 20 years ago. The insurance company is not required to meet these estimates, nor were they ever guaranteed. The only certainty about illustrated values is that the policy's actual performance will differ from the original proposals.

While the annual policy statement contains footnotes that can highlight a problem, it is usually missed in the six- to eight-page report and is filed along with the policy without much attention being paid to the early warnings provided by the insurance company. The best way to understand how a policy is performing is to order an in-force historic re-projection. This evaluation is an illustration of the policy from the inception to the present and contains its current values, which must now be projected into the future based on current guaranteed crediting rates and on current mortality costs. A universal life policy is based upon an assumed interest-crediting rate, while a variable universal life policy relies on the assumed subaccount yield. The difference between what was initially projected and what is currently needed will determine whether the current premium is sufficient to carry the policy to the age desired, or if it should be increased, and by how much.

A 2013 survey inTrusts and Estates magazine found that 83 percent of non-institutional trustees had no guidelines or procedures for handling trust-owned life insurance, and 95 percent had no investment policy statement covering TOLI. Additionally, only 28 percent of these trustees had reviewed TOLI within the last five years. Little attention is being paid to over a trillion dollars of liquid, tax-free, life insurance death benefits.

In the case of a lapsing policy with a loan, the policy owner can be subject to income taxes as a result of forgiveness of debt if the policy expires before the insured. Likewise, if a trustee or grantor forgets to pay the premium or assumes no premium is due when in fact it is, most insurance companies will automatically pay the premium to keep the policy in force and then count those premiums as a loan and charge a cumulative 5 percent interest rate on the loan each year. The trustee and the grantor may be unaware of this loan and consequently unaware of the accruing interest on that loan that is draining the policy and causing it to expire prematurely.

For the most part there is no procedure in place to properly manage a TOLI policy. Further exacerbating the problem is the fact that the insurance agent or broker may no longer be involved, and the insurance company, contrary to popular belief, is not obligated to make certain that the policyholder’s premium is sufficient to keep their policy in force. Nor is it in their interest that the coverage remains in force. The insurer stands to gain substantially if the death benefit were to be reduced or, better yet, even lapses as a result of a significantly higher premium due to the trustee neglecting to review their contract and making the necessary premium adjustments. Keep in mind that the insurance company is merely required to send out premium notices and provide one annual statement. The rest is up to the owner or trustee.

Therefore, every grantor of a TOLI and every trustee should have in place an actively managed annual review process, which includes a documented trust investment policy statement and an adequate funding statement outlining what’s important to the grantor and a roadmap for the trustee to follow under normal circumstances as well as in the event of certain future contingencies. In response to the backlash, the insurance industry has begun to offer “no-lapse guarantee riders” on universal contracts to insure against their premature lapse. However, many of these riders become null and void if the premium is paid even a day late. Unfortunately, not many people are aware of those practices.

If the client is healthy and it makes economic sense, they could consider the purchase of a new policy based on lower mortality costs, increased underwriting classifications, as well as additional benefits such as the ability to pay for long-term care costs directly from the death benefit, tax-free, that were not previously available. A trustee should make certain that premiums are properly and timely credited to the policy, and that all provisions are adhered to. They should also verify that insurance titling of ownership and beneficiaries is based on the insured’s current objectives, rather than relying on what was put in place years ago when the coverage was first applied for.

There is no better way to make certain you become an advisor to your client's next generation than to suggest a meeting with your client's son or daughter who are currently acting as trustee or owner of their parent's life insurance. They need to be informed of the problem and provided guidance regarding their fiduciary liability and responsibility so they will do what's necessary to maintain their parent's life insurance legacy, with which they've been entrusted.

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