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What Your Clients Wish You Told Them About Fixing & Preventing Mis-Managed Life Insurance From Affecting Their Estate Plan

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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 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 over 90% of the Fortune 500 corporate clients have a deferred compensation plan (DCP),[1] 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 key employees the ability to defer a portion of their income as a perk at their place of employment.

Similarly, their CPA's will prepare their Crummy letters and make certain there's sufficient funds available to pay the ongoing necessary premiums to keep the coverage in force beyond their life expectancy.

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 as well as their children acting as ''amateur/ accomodation trustees,'' that have received very little guidance regarding their responsibilities and the consequences of their actions and inactions when it comes to dealing with the current mismanagement and neglect of many of their existing life insurance policies in their portfolios. Life insurance has two purposes that can be used individually or combined to provide a traditional ''Death Benefit'' as well as a lesser known ''Living Benefit.''

Regardless of the use or purpose it's essential that a client understands that life insurance policies do not come with an automatic management function and that each of the policies funding their respective trusts

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[1] Reg Ed Non Qualified Deferred Compensation Course, p. 7 (Mar. 2017).

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and agreements require 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 over $400,000 in premium. Your action is needed immediately. What would you advise? The point is if you, the advisor, or your amateur trustee client doesn't have the necessary skills, to properly evaluate the existing policy coverage it's your responsibility to retain the services of someone that does.

HOW DID THAT HAPPEN?

All too often a person, be it the client's advisor or eldest child will accept the title of trustee but won't fully understand the ramifications, the responsibility, nor the fiduciary liabilities that comes 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 one million dollar life insurance policy it would have been suggested that the policy be owned by someone other than the insured outright, or if management and or creditor protection was desired, by a trustee of an ILIT, both to keep the death benefit out of the grantor's taxable estate. In 10% of the situations the grantor would have chosen to use an institutional or corporate trustee. However, in the other 90% it was usually the grantors' eldest child that was asked to serve as a trustee. A trustee that had the responsibility but not the necessary knowledge, experience, nor guidance to properly manage the life insurance policy to prevent it from expiring prematurely. Nor did the trustee realize that they assumed 100% of the performance risk for the life insurance policy that they didn't know was not guaranteed to last for the remainder of the insured's life.

WHAT HAPPENED?

The death benefit coverage of a life insurance policy could significantly be shortened as a result of 25-plus years of reduced sustained interest rates and neglect on the part of the amateur trustee, that wasn't aware that the life insurance premium he/she was paying should have been increased. The problem compounded itself over the years to the point where many 80-year old's today are currently discovering that their life insurance coverage is only going to last for just a few more years unless a significantly higher premium is paid to make up the insufficiency created over the last 25-plus years. How can that be asked of the client when they paid all of my premiums on time, in full and never borrowed any of the cash value. What they nor their amateur trustees, and advisors didn't understand is that 45% of the life insurance contracts they purchased over the last 25 years were non-guaranteed 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 10, 20, or 30 years ago that didn't materialize, and was never adjusted to coincide with the continuous reduced interest rate environment. This situation continued throughout the early 2000's 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 that the policy will last for the rest of an individual's life, or to a desired, specific age, in the case of a guaranteed universal policy.

However, with any non-guaranteed universal life policies purchased prior to the early 2000's, It was the owner/trustees' responsibility to evaluate the performance of the policy 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 the amateur trustees nor their advisers realized that a non-guaranteed life policy required this type of active management, and as a result 25-35% of these non-guaranteed universal life insurance policies are now expiring prematurely.[2] This situation has grown increasingly worse because just as people are living longer,[3] their non-guaranteed life policies are expiring earlier.

Most life insurance policies, even whole life policies, require some form of active management due to the fact that dividends which are often used to buy term insurance or reduce premiums are not guaranteed, 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

[2] Randy Whitelaw and Henry Montag, *The Life Insurance Policy Crisis*, ABA (Jan. 2017).

[3] Society of Actuaries Report (Nov. 2014).

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who can be blamed for their problem. ''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% of the trustees that 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 the above questions is ''No.''

Neither the agent nor the company is responsible. It's the trustee that has 100% 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

In August 2012 the Office of the Comptroller of the Currency (OCC) issued guidelines[4] which directed financial institutions serving as corporate trustee of an insurance trust to treat life insurance as they would any other asset. Meaning that life insurance, like stocks, bonds, and real estate, requires active management.

Providing a policy performance evaluation and then monitoring it every two to three years, depending upon product would be a good idea for all amateur trustees. This is similar to the directive issued to corporate trustees under the Uniform Prudent Investor Act (UPIA), that also mandates that life insurance be treated as any other trust asset.

IMPACT OF COI

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 rate environment and are currently seeking to do whatever they can to offset their losses.

Please inform your clients that the life insurance company has no obligation to the insured nor 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 they will never have to pay out a death benefit. A very profitable situation for the insurers as all they're required to do is provide a policy stating the coverage, send out the premium notices and the annual summary statements, that most people don't read, and by virtue of inertia individual life policies are expiring years earlier than anticipated. To further enhance this process an increasing number of insurance companies are now exercising their contractual right to increase the internal cost of insurance (COI) for the 45% 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' which is now further exacerbating an already deteriorating situation causing more life policies to expire even sooner. So, just as people are living longer their life insurance coverage is expiring sooner.

DO I STILL NEED THAT POLICY?

Considering the uncertainty of estate taxes, many of your clients are now pondering what to do with the life insurance they had previously purchased with the intent of using it 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?'' Should I just stop paying the premium all together and keep the policy for as long as the coverage will last? 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 like they would a car or a house. Such a sale is transacted on the secondary market in which a hedge fund/ institutional investor 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. Such a strategy can also be used to rescue a failing life insurance policy as a result of neglect or even unpaid loans against the cash value that could result in a significant tax bill, if the policy were to lapse, by turning an increasing premium bill into a liquid asset.

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

[4] *See* Comptrollers Handbook, Asset Management (AM): Unique and Hard-to-Value Assets (Aug. 2012).

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they want to make 100% certain that the life insurance policy they purchase, remain in force for the duration of their lives to support their child after they're gone or to provide an inheritance as a legacy allocated for the next generation. The solution is a personal choice predicated on one's personal finances and thoughts regarding longevity. An ongoing evaluation of one's policy can also determine that an individual age 75 or 80 with a significant health issue and an expected shortened life span should not be paying premiums to keep a policy in force to age 95 if their prognosis determines that they may not live beyond age 85. Although guaranteed universal policies are now available, a guaranteed policy is more expensive than a non-guaranteed policy, so make certain as a consumer you're educated and know what you're buying.

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 five 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 coverage, can later be used as an asset class to supplement their income at retirement. Keep in mind that some insurers only allow a term policy to be converted to a permanent product to age 65, or 70. This conversion privilege is extremely important to any individual that developed an illness, as it allows them to convert the policy's coverage to one that lasts a lifetime without any evidence of insurability. This opportunity is often missed and once it passes, is irreversible. point of information, association group term insurance is a great buy up until age 45, but with increases every five years at 50 it's terrible so shop around at age 49.

LIFE INSURANCE AS AN ASSET CLASS

Sometimes life insurance is not used for its death benefit and is instead used for its living benefit, as an asset class, i.e., providing a 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 for its living benefit 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 not violate MEC rules, and 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 the cash value on a favorable income tax free 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% of their 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

It's solely up to you, the clients trusted advisor who sees their client on an ongoing basis 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 and 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 ensure 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

Remember, your client may not be not familiar with their life insurance portfolio, may not know that it can expire years earlier than originally anticipated, is not comfortable talking about the subject, and does not understand how non-guaranteed life insurance and in-

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terest crediting rates work. In many cases the existing policy has not seen the light of day since it was purchased many years ago. Therefore, it becomes imperative that you, as their adviser, take a proactive role, and advocate for the next generation to assure that your client is aware that reduced sustained interest rates, neglect, and most recently the increased COI's has adversely affected the duration of their existing life insurance policies. 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 they need to locate, evaluate the performance, and actively manage their life insurance portfolio in order to preserve the life insurance inheritance left by your client, their parents, for them and their children.

While avoiding a policy lapse as a result of inadequate funding is the primary goal, it is important for the client to not waste assets and maximize the value of the life policies they currently have, as compared to what other policies may be available in the marketplace today. To assure that this is done, a client should be referred to an independent and experienced life insurance consultant to assist them in ordering a 'historic projection' to help determining whether they can take action today, which will prevent them from becoming a part of the increasing number of individuals whose life insurance policies have become compromised.

Doing so will allow a trustee to see how the policy might perform going forward based on the policy's current values, rather than on the originally illustrated projections that never materialized. A trustee may need to make some changes with or without additional costs based on the client's current objectives rather than on the original objectives made years ago that may no longer be relevant today. Trustees may find new features such as long-term care riders that pay for qualified long-term care expenses directly from the death benefit of a life insurance policy on a tax-free basis which were previously unavailable. Improved life expectancy as a result of modern pharmacology is now reflected in reduced pricing of new policies. Insurers are now offering guarantees which previously didn't exist.

In some cases, it may be less expensive for a trustee to purchase a new policy, even though the insured is older, through the use of an older policy's cash values transferred through a I.R.C. §1035 tax free exchange. This action should only be taken after weighing such considerations as changes in an insured's health, new surrender charges, and the beginning of a new contestability period. Other options may include reducing the current death benefit or increasing the premium. As previously mentioned, if the other options don't solve the problem a trustee should consider the sale of all or a part of a policy to turn an increasing premium into a cash asset as a result of a life settlement to a third-party institutional investor, or a combination of the above-mentioned strategies.

While it may be easier for an attorney to draft an exculpatory clause in a client's 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 or the client's CPA is the logical choice as the professional advisors who are in the best positions to arrange, invite, and manage such an initial meeting with the assistance of an independent experienced life insurance professional.

The point is, the sooner the problem is brought to the attention of the client, insured, owner, amateur trustee, grantor, or beneficiary, the more options they will have available, and less costly it will be for them to resolve their problem.

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