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Less Familiar Life Insurance Traps and Uses in a Client's Estate Plan

BY HENRY MONTAG

Clients and their children acting as ''amateur/accommodation trustees'' have received very little guidance regarding their fiduciary responsibilities and the consequences of their actions and inactions. The following is an outline of the use of several traditional and one not-so-traditional life insurance strategy along with how to put these policies to their best use.

The Many Common Roles of a Life Insurance Policy We all know that a life insurance policy can be used to fund an irrevocable life insurance trust (ILIT) to provide liquidity for estate taxes. It can be used via a grantor trust by a parent or grandparent seeking to provide family income, professional management, and shield a client's and their beneficiaries' assets from their creditors, all in an attempt for you to help your client's eldest child to do their job of maintaining the life insurance inheritance earmarked for the entire next generation.

It's also an ideal funding mechanism for a buy-sell agreement to assure the orderly transfer or disposition of a business interest for the benefit of their family and business partners.

The Lesser-Known Roles of a Life Insurance Policy In addition, a cash value life insurance policy can be used to fund a spousal limited access trust (SLAT), which is a very useful remaining estate planning strategy that preserves the federal exemption before it is reduced. A SLAT is an irrevocable trust created by a spouse for the benefit of the other during their lifetimes. The SLAT freezes the values of the gifted assets at their current value and excludes the appreciation from the estate of either spouse. It also provides the spouse the flexibility to retrieve the transferred assets if needed. Since it's a completed gift, it removes the transferred asset from the taxable estate and is not subject to estate taxes.

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The Living Benefits of a Life Insurance Policy Few key executives and business owner clients are aware that they can supplement their retirement income through the use of a supplemental owners retirement plan (SORP) that permits an individual to defer a portion of their income today into a life insurance policy that allows the cash value to grow on a tax-deferred basis. Then in the future the funds can be distributed to the client tax-free, as long as the policy survives the insured.

Life insurance can now be bundled with a long-term care insurance benefit allowing an individual to withdraw the costs for qualified long-term care expenses directly from the death benefit of a life insurance policy income tax free. One must, however, do the comparison with a traditional long-term care policy and a traditional life insurance policy to see if this strategy works in their situation.

The Special Opportunity for the UHNW Client in a Family Office The ultra-high-net-worth (UHNW) individual, or family office client and their advisor have a unique life insurance strategy at their disposal as a direct result of today's increasing marginal tax rate environment and a change in tax code Section 7702 that now allows a larger amount of accumulated cash value to grow and accumulate tax-deferred indefinitely in a life insurance policy. These combined changes have made private placement life insurance (PPLI) even more efficient than it was just last year. Equally significant, PPLI offers better pricing, and lower costs due to participants having better health care access. These fac-

tors, in addition to significantly reduced institutional rather than retail commissions, have resulted in a larger cash value buildup with no early withdrawal penalties.

Such a strategy offers access to institutional hedge funds rather than traditional retail mutual fund firms. The combination of hedge funds in a tax-deferred insurance company wrapper provides for very tax-efficient investment returns. While the strategy offers significant benefits to the owner, it is costly in that it requires an experienced team of an attorney, an accountant, and an insurance professional to properly structure and maintain such an arrangement. Minimum annual premiums would start in the range of $3 million-$4 million to initiate and fund such a policy.

How Would You Handle This Situation at Your Office? How would you advise a client's son or daughter acting as an unskilled accommodation trustee of an ILIT to react to receiving a notice from the insurer stating that the $1.7 million life insurance policy funding their dad's trust is going to lapse in the next 11 months unless a significantly higher premium is paid? The insured is age 81, and has so far paid over $400,000 in premiums. Your action is required immediately. What would you advise? The point is if you, the advisor, or your unskilled trustee client doesn't have the necessary skills to properly evaluate the performance of the existing policy, understand the situation, and determine the best direction, then it's your responsibility, as the client's attorney, CPA, or wealth manager, to retain the services of an experienced independent trusted expert that does.

The Insurer's Obligation Keep in mind that the life insurance company has no obligation to the insured or their beneficiaries. Instead, its obligation is to its stock or shareholders. When a life insurance policy lapses, or is surrendered, 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. Subsequently, an increasing percentage of non-guaranteed life insurance coverage is expiring before the insured.

To further enhance this windfall, an increasing number of insurance companies are now exercising their contractual right to increase the internal cost of insurance (COI) on the 45% of the existing non-guaranteed universal life insurance policies. This action, in addition to 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 prematurely. So, just as people are living longer, their life insurance coverage is expiring sooner.

In Summary Considering the uncertainty of estate taxes, and the fact that an increasing number of existing life insurance policy coverages are expiring prematurely, many of your clients are now pondering what to do with the life insurance they previously purchased.

The question becomes should I continue to pay an increasing premium for insurance I may no longer need or can afford, or should I give up my coverage? If I decide to give up my coverage, what should I do?

Depending on an individual's health and age, a smarter but less well-known option for an individual aged 70+ in less than average health, is an alternate exit strategy known as a "life settlement." The insured sells all, or a portion of their existing life insurance policy on the secondary market to an institutional investor. Doing so always provides the seller with a higher payout than had they surrendered the policy back to the insurer. This strategy can turn an increasing premium bill, or a policy that's no longer needed, into an additional liquid asset able to be used for any purpose.

Families would be best served if they made the time and devoted the effort to better understand their life insurance portfolios and their options.

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