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# When Premature Life Insurance Expiration Disrupts an Estate Plan

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*Non-guaranteed life insurance policies may expire earlier than expected due to decades of reduced sustained interest rates and fiduciaries need guidance on how to prevent that from happening, says Henry Montag of The TOLI Center East.*

While there are numerous aspects of our lives that we cannot control, there are strategic steps that clients can be advised to take that will will mitigate their financial risks and result in a predictable and known financial outcome for them. No, we're not speaking about investment risk, as there's no such thing as a predictable and known outcome in that world. Instead we'll examine several financial planning strategies that, if properly identified and drafted with appropriate wording by an experienced attorney and combined with a properly selected and managed insurance product, can go a long way in minimizing the risk for a client who otherwise may have been headed for a loss of assets. We'll be discussing the typical issues as they relate to the everyday life of a typical Bloomberg reader and their clients.

For example, trusts and business agreements are set up for clients for a variety of reasons. An irrevocable life insurance trust (ILIT) is used to provide liquidity for estate taxes. A grantor trust is set up for a parent or grandparent wanting to provide family income, professional management, and guidance for an inheritance earmarked for the next generation. A special needs trust (SNT) provides for the welfare of a child after their parents are no longer here to take care of them. A spousal lifetime access trust (SLAT) can be set up to arrange tax-friendly reciprocal trust benefits for a husband and wife.

A buy-sell agreement is used to assure the orderly transfer or disposition of one's professional or 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) many 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.

### *The Role of a Life Insurance Policy*

What do all of these trusts, buy-sell and other agreements have in common? A life insurance policy funding them. It's therefore important for the grantor as well as the amateur/accommodation trustee, usually the grantor's eldest child, to know their responsibilities as well as their fiduciary duties and legal liabilities associated with managing the various types of life insurance policies funding these trusts and agreements. If they don't, they may effectively let the life insurance coverage expire years earlier than anticipated, rendering useless the agreements and trusts that rely on the coverage.

### *When Amateur Trustees Don't Understand Their Fiduciary Responsibility*

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, 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.

In the 1990s, if a client purchased a $1 million life policy it would have been suggested that the policy be owned by someone other than the insured to keep the death benefit out of the grantor's taxable estate. In order to do so, an attorney would draft an ILIT that, besides being irrevocable, would also provide management and creditor protection. In only 10% of the situations would the grantor have chosen to use an institutional or corporate trustee, simply because such trustees charge a fee and very few grantors are willing to pay that fee. In the other 90%, the trustee was most often the grantor's eldest child or a friend. A trustee who had the responsibility but not the necessary knowledge, experience, nor guidance to effectively

manage the life insurance policy to prevent it from expiring prematurely. Typically, this amateur trustee who unwittingly assumed 100% of the performance risk for the policy wasn't aware that the duration of their coverage was not guaranteed and required active management in order to remain in force for the remainder of the insured's life.

During the ensuing three decades of reduced sustained interest rates, the amateur trustee wasn't aware that the life insurance premium should have been increased to make up for the reduced interest crediting rates. In other words, not paying a larger premium caused the duration of the death benefit coverage to be significantly shortened.

Consider this, if you keep paying the same premium and maintain the same coverage but earn less of a return then the only variable is the duration which results in the coverage ending sooner than expected. As a result, many 80-year-olds today are discovering 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 for the insufficiency created over the last 25-plus years caused by reduced interest rates and neglect.

This does not go over very well with an octogenarian client who hopes they will live for another 10-plus years. "How can that be?" asks the client. "I've paid all of my premiums on time, in full and I never borrowed any of my cash value." What neither they nor their amateur trustees and advisors understand is that the contract they purchased 25 or 30 years ago (in the majority of cases) was for *non-guaranteed* universal life insurance. The premium was set based on an anticipated interest rate in the range of 9-10% that didn't materialize. Most trustees mistakenly treated life insurance as a "Buy and Hold" asset rather than as a "Buy and Manage" asset. They assumed that the insurance company was automatically going to determine and increase the billed premium necessary for them to continue the coverage for the rest of their lives. Instead, the insurance company continued to send them the same billed premium which has resulted in an increasing number of non-guaranteed life insurance policies pre-deceasing the insured.

This is and has been a recipe for financial disaster as it often leads to amateur trustees being sued by their siblings for wasting a financial asset, that they were responsible for maintaining for the trust beneficiaries, their siblings' families.

***How Should You Handle This Situation?***

It's essential for a client to understand that life insurance policies do not come with an automatic management function and that the policies funding their respective trusts and agreements — be they universal, indexed, or variable policies — all require an ongoing review because unexpected personal events happen, and economic situations can and do change.

How would you as 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 do a stress test to evaluate the insured's life expectancy and the necessary premium to keep the coverage in force to a particular age, then it's their fiduciary duty as a trustee to retain the services of someone who does.

Once a problem is discovered, trustees and beneficiaries alike often begin looking at who is at fault and who can be blamed for their problem. "Isn't it the agent's responsibility, or "Shouldn't the insurance company have billed me correctly?" or "Shouldn't my attorney who drafted the trust or my CPA who is involved in all my financial decisions have advised or informed me?" The answer to the above questions is "No." It's the trustee who has 100% of the responsibility to manage the life insurance policy and is the only one authorized to increase or decrease the billed premium.

It's these life insurance policies that fund the trust that are used to provide the family with ongoing income. It's the buy-sell agreement that a business partner relies on to assure a deceased partner's family will get their appropriate payout with 100% tax-free life insurance proceeds upon that partner's death, thus allowing the remaining partner to retain 100% ownership in the business. Perhaps it's the deferred compensation plan an executive or business owner contributed to over the years to supplement their retirement income. Or it could be for the special needs trusts that a parent funded to make certain that their child's life will remain comfortable, even after their parents pass on.

A sizable portion of life insurance coverage is specifically purchased to pay for one's debts, administrative costs and state and federal estate taxes. As a result of sunsetting provisions in our tax laws, the federal exemption will decrease from approximately $12 million to $6 million adjusted for inflation effective January 1, 2026. This will result in even more individuals being required to pay a federal and state inheritance tax. Many individuals will rely on life insurance to pay these taxes since the proceeds (if set up correctly) will be income and estate tax free and, if it's a second-to-die policy, will be made available exactly when needed, at the death of the second spouse.

Because life insurance companies' profitability margins have been adversely affected by years of sus-


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tained reduced interest rates which severely impacted their earnings and the impact of Covid on their losses, they are currently seeking to do what they can to offset their losses. This includes raising their COI (Cost of Insurance), which further reduces the net crediting returns of a policy and further exacerbates an already deteriorating situation, causing a policy's duration to shorten even quicker.

Advise your clients that the life insurance company has no obligation to provide guidance to the insured nor the beneficiaries. Instead, their obligation is to their stock or shareholders. When an insured decides he can't or won't pay a significantly higher premium the policy lapses and the insurance company gets to keep all of the premiums that were paid, without ever having to pay out a death benefit. This results in a very profitable situation for the insurance company and not for your client.

But there are options.

### *The Life Settlement Option*

When it's discovered that a client's life insurance policy is in trouble of expiring years earlier than expected, the question becomes what should I do now? Should I surrender the policy back to the insurer in exchange for the cash value? Should I merely reduce the death benefit, or should I increase the premium paid to the insurance company to extend the duration of the coverage. Another option may be to just stop paying the premium all together and keep the policy for as long as the coverage lasts? 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 to an institutional investor, just like they would a stock, bond, or a parcel of land. This strategy most often yields a significantly higher payout than does surrendering the policy back to the insurer. Most importantly it turns an increasing premium bill into an asset.

### *An Unexpected Disability*

Another major disruptor to an individual's estate plan is an unexpected disability occurring during one's working years. The inability to earn a living is extremely disruptive and significant when an individual relies on a salary from their business or employer.

But such an occurrence can also have a devastating impact in one's retirement years as they weren't able to continue contributing to their I.R.C. §401(k) or §403(b) plans. While many actively working individuals purchase life insurance to protect their family, that's not the case with protecting themselves in the event of a disability. Perhaps the reason is that an inexpensive form of life insurance coverage called term life insurance exists, but that's not the case with disability insurance, despite the fact that individuals in their 30s to 50s are three times more likely to have a disability lasting at least a year than they are to die prematurely.

### *Protecting Against a Long-Term Care Expense*

Another major disruptor to a family's retirement plan is when a family member suffers an unexpected medical event requiring them to pay for an unreimbursed long-term care expense. Often times this is caused by an individual's loss of ability to manage their own activities of daily living such as eating, bathing, dressing, or transferring from one location to another. We all know the devastating impact that Alzheimer's or some other form of memory loss or dementia can have. While no one can take away the emotional hurt of having to deal with this problem there are financial and legal steps a family can take today to ease the burden and protect themselves should they become one of the afflicted individuals. An unexpected, unreimbursed long-term illness can have catastrophic effects on one's personal life as well as that of their family.

Today individuals have a choice of purchasing a traditional stand-alone long-term care insurance policy or the combo plan that allows an individual to withdraw cash on a tax-free basis from the death benefit of the policy. There are advantages and drawbacks to each, and they must be compared before a client decides which one to use.

Arrangements that people make or don't make while they are younger and healthy will determine the quality of life for themselves and their families going forward. Those who plan ahead will avoid having to deal with the financial and legal issues, in addition to the ever-present medical and emotional issues, thus avoiding a significant family crisis.

### *Term or Permanent Life Insurance?*

A buy-sell agreement between business partners can be funded with either a less expensive term life insurance policy, which is guaranteed to last anywhere from 5 to 30 years, but only 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 on a tax-deferred basis. This cash value can later be used to supplement their retirement income on a tax-free basis through a series of loans and withdrawals. If a business, or young family is first starting out and 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 plenti-


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ful, 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 allow a term policy holder the opportunity to convert to a permanent policy without any evidence of insurability up to age 65 or 70. This conversion privilege is extremely important to any individual who has developed an illness, as it ensures that the individual will be given the opportunity to convert their insurance coverage to one that will last for the rest of the insured's life, without any evidence of insurability. This opportunity is often missed and, once it passes, is lost forever.

A quick word about inexpensive group term life insurance offered through trade or professional associations such those for attorneys, CPAs, etc. The coverage is inexpensive until a person reaches age 45. However, with premiums increasing every five years, the premium will double at age 50 and triple at age 55. This association group term insurance coverage should never be used if the intent is to maintain coverage beyond age 55-60 as the cost is high and the coverage reduces at age 70 and ends at age 75.

Fortunately, Guaranteed Universal life insurance policies are available today. It's especially important for parents setting up a special needs trust to use a policy that's 100% guaranteed to remain in force for the duration of their lives and will be there to support their child after they are gone. Point of information, a guaranteed policy is more expensive than a non-guaranteed policy so make certain you know the type of coverage you or your client is purchasing.

***In Summary***

Keep in mind, your client is usually not familiar with their life insurance portfolio, does 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 interest crediting rates work. Many incorrectly believe that they are not healthy enough to qualify for certain coverages, or that certain coverages are too expensive. In many cases their existing policy(ies) has not seen the light of day since it was purchased many years ago. You wouldn't treat your stock and bond investment portfolio that way, and you shouldn't treat your risk management portfolio that way either. To remedy this situation and take advantage of many more little-known strategies, develop a relationship with an experienced independent life insurance professional (CFP, CLU).

It is imperative that you take a proactive role, advocating for the next generation by making your client aware that reduced sustained interest rates over the years may cause their life insurance coverage to expire before they do—totally disrupting their estate plan. Make certain your client, where appropriate, uses corporate/business assets to purchase personal benefits at the lowest available tax rates. Most importantly, the sooner a problem is identified the more options are available to fix the problem and to do so at a lower cost.

Life insurance today does more than provide a death benefit to the beneficiary; it can also provide a very significant living benefit to the insured as an asset class that takes advantage of the tax-deferred accumulation aspect and tax-free distribution benefits of a traditional or a Private Placement Life Insurance policy for the high- and ultra-high-net-worth client.

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