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What an Attorney and CPA Must Know About Maintaining the Life Insurance Coverage in an Irrevocable Trust (ILIT)

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The purpose of this article is to provide professional estate planning advisors with pertinent analysis and recommendations on life insurance developments in order to help them:

1. Protect their clients from any unexpected unpleasant surprises regarding their life insurance coverage funding their irrevocable life insurance trust (ILIT) expiring early.

2. Assist their clients in leaving as large a legacy as possible to their family via an ILIT.

The intent is to assist you in better understanding a life insurance portfolio from a personal, as well as a professional perspective. While the current federal estate tax exemption is approximately $11,500,000, it will sunset at the end of 2024 back to approximately $5,500,000. In addition, many states tax inheritances of more than $1,000,000. Life insurance plays a large part in settling the estate taxes which are due and payable within nine months of the date of death, with several exceptions, before any part of the estate can go to the family. Typically, your client's eldest son or daughter is asked to act as an unskilled/amateur trustee and is not aware that the life insurance for which they are responsible and, as a fiduciary liable, is possibly in danger of expiring prematurely. As a result of the passage of the Uniform Prudent Investor Act (UPIA), trustees are now held to a higher standard than under previous law. Trustees have been put on notice that they must treat life insurance as they would any other trust asset such as stocks, bonds, or real estate.

THE PROBLEM: UNIVERSAL LIFE INSURANCE MAY NOT LAST FOREVER

As a trusted adviser to your clients, you have an opportunity to educate them and their unskilled trustees concerning the fact that as many as 50–60% of universal life insurance contracts written over the last 25 years are not guaranteed and 35–40% of those policies (about a quarter of policies overall) are now in danger of expiring prematurely, as highlighted in *The Advisors' and Trustees' Guide. . .*, cited above (see press release). This has occurred as a result of significantly reduced interest rates coupled with neglect over the last two decades. It affects individually owned as well as trust-owned life insurance policies, as all non-guaranteed life insurance policies have been equally adversely impacted.

Prior to the mid-1980s there were two types of life insurance policies, both guaranteed.

- Term Life Insurance, in which a specific dollar amount of life insurance was guaranteed to remain in force for a specific period of time — one, five, 10, or 20 years — and at a specific guaranteed premium.

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- Whole Life Insurance/Permanent Coverage, which was guaranteed to remain in force for the insured's life as long as the stated premium was paid each and every year. Whole life policies contained a tax deferred accumulation account known as cash value which was credited 3% annually.

Creation of Universal Life

Prior to 1984, if a consumer wanted their life insurance coverage to last beyond age 80, when a term policy would expire, they had no choice other than to purchase a whole life policy whose cash value was growing annually at a guaranteed 3% while bank deposits or CDs had continuously increased the yield on their deposits which at the time were yielding 15–17% annually. As one can imagine, it wasn't long before the general public saw the economic sense in borrowing the cash value from their current whole life policy, or in some instances completely cashing out the accumulated cash value from their existing 3% life insurance policy and transferring it into a higher-yielding bank deposit.

Then E.F. Hutton, primarily known as an investment brokerage firm, realized that there was a competitive advantage to be first to market a welcomed new type of life insurance policy that was flexible and less costly to already dissatisfied consumers. The new E.F. Hutton life insurance company offered a competitive, flexible interest rate to purchasers of its newly created universal life insurance. This type of policy provided the insured an assumption that their policy would be credited with a more competitive interest rate than the 3% that was previously paid by a whole life insurance policy. A universal policy offered coverage beyond age 80, and an assumed yield of 12–14% for an assumed 20 or 30+ year period which, if rates matched expectations (which they didn't), could have resulted in a significantly lower premium than the traditional whole life insurance policy.

A new type of a life insurance product was born, and people were in a frenzy to set their own reduced premiums based on the non-guaranteed higher interest rate assumptions they or their agent used to calculate the anticipated premium. At the time there was no regulation and if someone wanted to assume a 12–13% anticipated rate of return they were free to do so.

By the late '80s, nearly every major life insurance company offered a universal life policy. Consumers and agents were more concerned with the assumed interest rates and lower premiums than with the fact that the assumed interest rate was not guaranteed.

However, if the assumed interest rate was not achieved consistently over the next 20 or 30+ years, the duration of the coverage would be shortened. Consumer and agents were not aware that the actual achievement of the assumed interest rate should have been recalculated every few years. For example, if the credited rates increased, they could have paid a lower premium — but if interest rates decreased, as they continuously did, then the premiums should have been increased to make up for the lower actual return. In other words, non-guaranteed life insurance should have been treated as a buy-and-manage asset rather than as a buy-and-hold asset.

Types of Trustees

Many accountants and attorneys have suggested that their high-net-worth clients use an institutional trustee for their trust-owned life insurance policies, while many others have chosen to serve as trustees of such trusts themselves. Since many institutional trustees charge a fee for their service, very few trust-owned life insurance (TOLI) policies — less than 10% — use a corporate/institutional trustee to professionally manage a client's irrevocable life insurance trust (ILIT). 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 Controller of the Currency (OCC), which monitors their activity on an annual basis. If their offices don't have the necessary expertise to evaluate the performance of a policy, they would of course retain the services of an expert who does.

The other 90% of TOLI policies are managed by the grantor's son or daughter who for the most part, acting as unskilled trustees, don't have the basic understanding that the policies for which they're responsible are not guaranteed and require active management just like their stock/bond or real estate portfolios, otherwise their coverage could expire prematurely — as increasing proportions of them already have. Most trustees are unaware that they've assumed 100% of the performance risk as well as the fiduciary responsibility and liability when they agreed to act as a trustee for a non-guaranteed universal life insurance policy. Since most unskilled trustees are not equipped to evaluate the risks, nor monitor the performance, of a non-guaranteed universal life insurance policy, they are unlikely to do what is necessary to remediate the underlying problems to prevent premature expiration.

While the majority of problem has come from flexible premium, non-guaranteed universal policies, the problem extends to variable and even whole life insurance contracts that are being paid for out of their cash value — when the owner or trustee fails to pay a premium, for instance.

The Source of the Problem

So how can the attorney/accountant, acting as trustee themselves or an adviser to the policy owner/

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trustee know if their or their client's universal life policy has problems? The original illustration is generally of no help since life insurance illustrations are simply computer printouts that show various aspects of the policy, i.e., premiums, cash values and the duration of the death benefits using assumed interest crediting rates often made 20+ years ago when assumed interest rates were significantly higher than they have been over the recent past. 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 6–8-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 increasing mortality costs. A universal life policy is based upon an assumed crediting rate often set by the insurer's board of directors annually, while a variable universal life policy relies on the assumed sub-account stock or mutual fund returns. The difference between what was initially projected and what is currently needed determines whether the current premium is sufficient to carry the policy to maturity or if it should be increased.

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 from the cash value to keep the policy in force. Further, it will consider those premiums as a loan and charge a cumulative 5% interest rate on the loan each year. The trustee/owner is often unaware that this loan accrues interest compounding each year and draining the policy's cash value until it prematurely expires.

A Necessary Procedure

My 35+ years' experience as a practitioner has led me to believe me that a typical unskilled trustee has no procedure in place to properly manage a TOLI policy. Further exacerbating the problem is the fact that, contrary to popular belief, neither the insurance agent/broker nor the insurance company are obligated to make certain that your premium is sufficient to keep your policy in force. Nor is it in the insurer's interest that your coverage remains in force. The insurer after just eight years of an insured paying a premium, breaks even and after 20+ years stands to gain substantially if the policy lapses, because then it retains all the years of premiums paid without ever having to pay out a death benefit. Keep in mind that the insurance company is merely required to send out premium notices to the insured, provide one annual statement and pay the death benefit if the policy is in force at the time of the insured's death. The management of the policy to make certain the premium is sufficient to maintain the death benefit to a desired age is solely up to the owner/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 (TIPS), stating how the trust asset should be managed and what's important to the grantor under normal circumstances as well as in the event of certain future contingencies such as required premium increases. An Adequate Funding Statement (AFS) outlining the financial evaluation to assure the premium is adequate to maintain the coverage. In response to backlash and complaints, the insurance industry has begun to offer "No-Lapse Guarantee Riders" to new universal contracts to prevent their coverage from expiring prematurely. However, they do not apply to any of the non-guaranteed policies issued prior to the creation of these riders.

SOLUTIONS TO FIX A FAILING LIFE INSURANCE POLICY

An insured could start paying a higher premium to guarantee that a policy's coverage will not expire earlier than five years beyond their normal life expectancy. Or the death benefit could be reduced to a smaller amount without adjusting the premium. If the client is healthy and it makes economic sense, they could consider the purchase of a new policy available in the open marketplace today, based on lower mortality costs, and increased underwriting classifications. In addition, they could take advantage of new "Living Benefits" of Life Insurance as an "Asset Class," which was previously unavailable. This includes the ability to *pay for long-term care costs directly from the death benefit, tax free.* If it's determined that the necessary premium is more than the insured wishes to spend, or can afford, the trustee should retain the services of a *licensed life settlement broker to sell the policy as a life settlement* in the secondary market to an institutional investor rather than simply allowing the policy to expire worthlessly. It's been my personal experience as a practitioner that this strategy can re-

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turn upwards of 100% more than an insured would receive if they were to merely surrender the policy to the insurer for its cash value. With proper guidance and intrafamily communication, a trustee or individual owner can turn a bill into an asset. If intervention is needed, the logical go-to is a tax or legal advisor working in conjunction *with an experienced independent life insurance consultant familiar with these issues.*

The trustee should make certain that all beneficiaries are based on the insured's current wishes, rather than rely on what was put in place years ago when the coverage was first applied for. There is no better way to inure yourself to the next generation than to suggest a meeting to assist the son or daughter responsible for maintaining and managing a significant amount of life insurance allocated to financially assist the next generation by paying their estate taxes and maximizing the legacy left by their parents. The most important question in addition to inquiring how much life insurance is available, is to ask: *How long is your current life insurance coverage guaranteed to last? How do you know?*

Educate on Any Trustee Hold Harmless Clause

If a trust contains a hold harmless provision, make certain the grantor is aware of its existence and its meaning. Since the trustee has the sole responsibility for managing the trust asset, if he or she lacks life insurance evaluation expertise and the trust has a hold harmless provision, how will it affect the management and the ultimate duration of the life insurance coverage? Might it not make more sense to provide the amateur trustee with the guidance he/she will need, rather than allow the beneficiaries' inheritance to suffer because the grantor didn't want to ensure that the trustee could fulfill the responsibility entrusted to him/her?

Advocate for the Next Generation (of Clients)

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 regarding the current state of their life insurance coverage and to let them know that it's important to determine exactly how long their existing coverage will last based on the current premiums they're paying and what can be done to preserve the inheritance left by your client, their parents. While it may be easier to draft an exculpatory clause in the trust, rather than 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 CPA is the professional advisor best positioned to arrange, invite, and manage such an initial meeting.

IN SUMMARY

In conclusion, you as a trusted advisor can choose to anticipate and avoid various family infighting and finger pointing as to who is to blame for a significant amount of life insurance coverage disappearing as a result of a lack of proper management. You can do this by setting up your own system taking all of the above into consideration. Or if you don't have the inclination or expertise, you can suggest that an unskilled trustee retain the services of an independent non-biased consultant who will evaluate, monitor, and review their life contracts and make suggestions based on additional ways to take advantage of various preventative measures or, if needed, provide some positive remediation strategies. Your clients will thank you.

The better approach for all parties is to require that the trustee treat a life insurance policy like any other trust asset, evaluating it and determines its appropriateness on a continuing basis — and getting paid for these services. Sometimes, penny wise really is pound foolish — for both the payor and the payee. It should be obvious that while relieving a trustee of various duties may lower the cost in trustee fees, it will also leave the trust without anyone to assure that the full value of the death benefit gets to the family.

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