

Subject: Marty Shenkman's Meeting Notes from Heckerling 2017, Day 3 Afternoon Notes

Heckerling Institute 2017 – Wednesday, Day 3 Afternoon Notes

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The following are rough draft meeting notes prepared at the 2017 51st Heckerling Institute on Estate Planning sponsored by the University of Miami School of Law, and published in Leimberg Information Services, Inc. (LISI). These notes were published within a very short time of the conclusion of the proceedings and could not have been reviewed in order to be completed so quickly. There are no doubt errors, typos, etc. in these notes none of which should be attributed to the presenters. LISI obtained special permission from the Heckerling Institute to publish these notes. Bear in mind that no notes appear below on more than 20 concurrent and other sessions. These sessions can be purchased from the source listed below. The final papers presented at this year's Heckerling Institute can be obtained from Lexis Nexis. For recordings of the sessions contact Convention CDs, Inc. 800-747-6334.

ABA Book Launch: Trust Owned Life Insurance TOLI Issues.

- a. The following remarks and comments are based in part on a review of a recent book *The Life Insurance Policy Crisis* by E. Randolph Whitelaw and Henry Montag published by the American Bar Association, in part based on an article I wrote that appeared in the appendix to the book, remarks made to a presentation about the book January 11, 2017 at Heckerling, and some additional thoughts and comments as to how the changing estate planning environment may have a significant impact on all of this. To purchase Henry and Randy's book go to www.shopABA.org.
- b. Some startling statistics from the book emphasize the importance of practitioners encouraging all clients to monitor their insurance coverage and certainly for trustees of ILITs.
 - i. 90% of ILITs are managed by trustees that have no particular background or skill to manage life insurance.
 - ii. About 39% of in force non-guaranteed universal life policies, and 34% of in force variable universal life policies, are illustrated by the carriers to lapse during the insured's lifetime or within five years of life expectancy. While this sounds incredibly worrisome, it likely understates the problem. There is a significant correlation between wealth and longevity so that the clients that have significant life insurance inside life insurance trusts are likely to have greater than average life expectancy.
 - iii. Those over age 65 appear to lapse life insurance policies at a shocking rate. Based on 2008 data 1.1 million policies with a face value of \$112 billion were lapsed. It appears that few of these considered the possibility of a sale of the policies prior to lapse.
 - iv. In 2013 the insurance policy lapse rate was 5.7%. 82% of those were merely allowed to lapse with no value to the owner.
- c. ILIT issues arise with common frequency in practice.
 - i. Policies about to lapse or that have lapsed because no one had looked at the performance of the policy or the carrier since the policy was purchased decades earlier. **Example:** In one case the client retained counsel to pursue the matter. When presented with two separate retainer agreements that expressly excluded life insurance selection the law firm opted only to pursue the insurance broker.
 - ii. Policies cashed in instead of being sold or retained because a client with no input from any adviser decides they no longer need the policy because the estate tax has become less relevant or irrelevant. **Example:** A surgeon by the time he came to me for an initial consult had cancelled a number of Guardian Life policies that had been in force for nearly two decades and which were all owned by a well-crafted ILIT. His reaction was that he did

not need it because of the increase in the estate tax exemption in 2013 without any consideration of the income tax and significant asset protection benefits the well-done plan had afforded.

- iii. A policy and trust that may be adequate but for which there are no records. Often there are changes in trustees that have never been reported to the insurance company and no documentation of those changes. **Example:** A new client presented an existing ILIT. The ILIT was so old that the only copies of the trust anyone could find were missing several pages. There were two changes in trustees none of which had been reported to the carrier who continued to list the initial trustee, and the documentation appointing the successor trustees was also lost. Consider preparing a compilation of the trust instrument and all consents, actions or documentation from inception to date anytime there is a significant change.
- iv. The policy is found to be adequate but the trust instrument no longer serves the client purposes so a combination of trust protector actions, decanting, disclaimers, etc. may correct the problems. **Example:** The initial ILIT held funds in trust from a survivorship policy until each child was 35. At the time of evaluation each child was 50+. The old ILIT was decanted into a new ILIT with similar timers but lifetime trusts for the children.
- d. Flexible premium non-guaranteed death benefit policies have become common and many clients and individual ILIT trustees do not understand that these policies shift the performance risk from the insurance company to the policy owner.
- e. Life insurance can be viewed as an asset class: the death benefit does not correlate with other asset classes, tax deferral and tax free withdrawals and loans are unique features that differentiate insurance from other assets.
- f. Trusts, including ILITs, are the keystone of most estate plans. Whether a client has sought asset protection benefits, estate tax savings, probate avoidance, or most recently basis step up techniques, trusts have often been part of the solution. The incredible flexibility that trusts bring to financial and estate planning has placed them in a position of prominence in the planner's toolkit. An essential component of every trust plan is the client's selection of fiduciaries. Most clients have, and continue to, shun institutional trustees. After all, institutional trustees charge fees, and are rigid in their willingness to act. The solution to many clients appears simple, an individual trustee that is typically a close family member or occasionally a friend. While theoretically that decision can provide as beneficial a result as naming a skilled institutional trustee that is unlikely to be the case. The siren call of simplicity and low cost too often leads clients and their families down a dangerous path.
- g. Duties of the ILIT Trustee.
 - i. The terms of the trust agreement create obligations on the trustee as do state law. The Prudent Investor act may apply.

- ii. Because IRC se. 2042 prohibits the grantor/insured from retaining incidents of ownership in the policy the grantor/insured cannot exercise powers of the policy, the trustee must do so.
- h. Family and friends can serve effectively as trustees, but most will require professional guidance to do so.
 - i. The means of achieving this positive fiduciary experience, for the both the trustee serving and the beneficiaries involved, is rather simple and obvious to the professional adviser, but unfortunately not so for many if not most individual trustees.
 - ii. Individual trustees should meet with appropriate professional advisers before beginning to serve. A trust attorney and dissect the trust governing the trustee position so that the trustee can understand in specific terms what the trustee's rights, duties, obligations and so forth are. Annotating and or summarizing the trust instrument to create a more accessible guide to the provisions of the governing trust. A checklist of operations can also be quite useful. Council should advise the client trustee about the importance of periodically reviewing the operations and status of the trust, communications with and distributions to beneficiaries, etc. Unless counsel has the expertise to address insurance specifics consider expressly excluding in the retainer letter insurance design and selection decisions.
 - iii. Meet with a CPA who has specific expertise in trust income tax planning to general planning implications, year-end tax planning if the ILIT holds more assets, and trust recordkeeping. The CPA should arrange for the filing of Form 56 informing the IRS of the new trustee relationship and Form 1041 if applicable.
 - iv. Meet annually with the professional advisers guiding the investment in trust assets if the client is not an expert in the field. This might be, depending on the nature of the trust, a wealth manager for marketable securities, an insurance consulting for life insurance, or other specialist. Certainly the key take home message of the book is that periodic reviews by an insurance expert to actively monitor insurance coverage. This is important as the ILIT trustee should demonstrate a reasonable process of evaluation of steps taken. See *Cochran v. KeyBank*.
 - v. Non-professional ILIT trustees need to understand that life insurance is not a buy and hold proposition but rather an asset that must be actively managed including the following steps:
 - 1. Life insurance policy statement.
 - 2. Product suitability and product design determinations. This is complicated by the broad range of products and product enhancements insurance companies offer.
 - 3. Carrier selection and underwriting.
 - 4. Annual performance monitoring and risk management.
 - a. Is the policy performing in a manner consistent with the illustrations?
 - b. What is the insured's age at the date the policy is projected to lapse?

- c. Are policy charges competitive?
 - d. Has the insured's health changed? Consider an actual life expectancy analysis.
 - e. What riders exist?
- 5. Periodic remediation and restructure. The book caution how replacement of policies, while sometimes warranted can be detrimental to the client/policy owner. A new policy may provide a more efficient premium and new benefits. If a policy is sold into the life settlement market consider the income tax implications. Rev. Rul. 2009-13. Agents may have an obligation to inform policy holders of the existence of the life settlement market. Larry Grill et. al. v. Lincoln National Life Insurance Company, 5:2014 cv 00051 S District court, California Central District.
- vi. While there are certainly more steps individual trustees can and should take, it is not that difficult or costly to hire the appropriate experts to guide the trustee in carrying out his or her fiduciary duties. Appropriate professional guidance, with a modicum of recordkeeping, diligence and follow up, may suffice for many individual trustees. The reality is that few individual trustees consult with professional advisers after the trust is formed other than to have an accountant (and not always one with particular trust expertise) prepare income tax filings, unless and until a problem arises.
- i. Individual Trustees Do Trip Up.
 - i. While it might be theoretically possible for an unskilled individual trustee to carry out his or her duties in a reasonable manner without consulting professional advisers regularly, unless that individual trustee has particular knowledge and training, or is one of those rare individuals who thoroughly researches and tackles the unfamiliar, that positive result may be unlikely.
 - ii. Consider the nearly ubiquitous ILIT trust administrative step of completing Crummey powers. How many individual trustees that do not work with their professional advisers actually complete this task reasonably well with any degree of consistency? If this task is not completed often or well, what of more complex tasks?
 - iii. How many individual trustees have an investment policy statement ("IPS") governing the trust they serve? How many individual trustees are even familiar with what an IPS is?
 - iv. Individual trustees should solicit trust beneficiaries to identify information relevant to the trustee decision making. How can a trustee identify beneficiaries to whom distributions may provide an overall tax benefit without knowing the current and likely future tax status of the beneficiaries? How can, in the context of an ILIT, the trustee assess the continued relevance of the original rationale for the insurance plan, policy design, etc.?
 - v. When is the last time individual trustees have reviewed life insurance held in a trust for which they serve as fiduciary? What is the likelihood of a trust insurance plan succeeding without regular professional involvement?

For many ILITs, not particularly likely. This is a key point of the book and why it goes to lengths to stress the importance of advisers guiding unskilled (in terms of life insurance knowledge) ILIT trustees to retain appropriate experts to assist in monitoring coverage.

- vi. For ILITs when is the last time that an individual trustee inquired with some specificity as to the health status of the insured? This might actually be a task that is more difficult for the family member or friend than an institutional trustee to perform. How can the appropriateness of an existing life insurance program be evaluated without the trustee having any current medical knowledge?
- vii. How many individual trustees have sought guidance as to the usefulness of a particular ILIT insurance plan in light of the dramatic changes in estate and income tax laws in the 2012 tax act? How many have simply cancelled existing policies and terminated ILITs (typically with no formal documentation) because “the policy isn’t needed any longer to pay estate tax,” with no analysis whatsoever of the performance of the policy, income tax benefits, possible legacy building and other non-estate tax paying purposes? Few of these individual trustees could imagine the liability exposure they might face for inappropriate cancelling a policy with no supporting corroboration. If the Trump administration eliminates the estate tax as proposed, there is likely to be a flurry of cancellations or surrender of ILIT policies for their cash value. Individual ILIT trustees should be warned not to act in haste. Before any modification of the coverage consideration should be given to the original purpose for the policies and the relevance of those factors in the current environment. While a policy may have been purchased to pay a federal estate tax that no longer applies, it may still have relevance to pay a state estate tax or a capital gains tax on death the Trump administration has proposed.
- viii. Even if the individual trustees take the appropriate action, in many cases they fail to document that action to demonstrate why their action was reasonable, or to inform beneficiaries of their actions and the reasons for them. Endeavoring to corroborate the rationale for an action after the fact is never easy and rarely as persuasive as contemporaneous records.
- ix. As the population continues to age and the myriad of existing trusts mature, the potential for problems with these informalities mounts, and the likelihood of lawsuits grows.
- j. Worse Issues with Individual ILIT Trustees.
 - i. While the “bad” steps above that are so common with individual trustees at the helm of the trust are substantial, individual trustees because they often do not adhere to trust disclosure rules or other formalities may well be tempted to engage in inappropriate self-dealing transactions, mismanagement, over charging and worse. Unless checks and balances are built into the trust (e.g., a trust protector, specified reporting, a co-trustee, etc.) the ability to take advantage of the position of being a trustee, or even to defraud beneficiaries, may be too great.

- ii. If the trustee can use trust resources to pay legal fees that can often be a potent weapon that alone can dissuade struggling beneficiaries from pursuing accountability.
- iii. Professional and institutional trustees often make a concerted effort to communicate with current and even certain remainder beneficiaries absent quiet trust provisions or extenuating circumstances. Individual trustees may not be aware of the obligation to communicate with beneficiaries about the trust. How likely is it that some or even many beneficiaries do not even know of the existence of the trust?
- k. Modern trust drafting, with increasingly complex mechanisms (e.g., swap powers to create grantor trust status and powers of appointment to secure basis step-up) and more fiduciary and other positions (administrative trustee, investment advisor, trust protector, etc.), have made some ILIT trust administration a more involved and variable endeavor. All these trends will increase the advantages of using professional or institutional trustees over individual trustees, or having a proactive professional term working with the individual trustee.

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