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What the Advisor Needs to Know About Trust Owned Life Insurance

By Henry Montag[*]
The TOLI Center East
New York, NY

Several years ago, you may have accepted an invitation to become a ''Trustee'' to one or more of your clients trust owned life insurance policies (TOLI). If so, this article may assist you in assessing your fiduciary responsibility and best practices to assure that you've done the best job for your client and their beneficiaries. In addition, it will also help you avoid any unpleasant surprises, as well as legal exposure to the fiduciary liability that comes along with the title. This article will also assist you professionally when informing and guiding your client's trustees, often their sons and daughters, acting as unskilled or amateur trustees. The information in this article will assist them in preventing the life contracts they're responsible for from expiring prematurely. In addition, 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. It should also be noted that those practices apply equally to life insurance as they do to any other asset class such as a stock/bond or real estate portfolio.[1]

As one of your client's trusted advisers, you have an opportunity to educate your clients concerning the fact that as many as 50-60% of non-guaranteed universal life insurance contract's written over the last 25 years are in danger of expiring prematurely.[2] This has occurred as a result of a significantly reduced interest rate environment and neglect over the last two decades. It affects individually owned as well TOLI. policies as all non-guaranteed life contracts have been equally adversely affected.

Many accountants and attorneys have suggested that their high-net-worth clients use an institutional trustee for their TOLI policies, while many others have chosen to serve as trustees of such trusts themselves. Since many institutional trustees charge a fee for their service, only a small portion of TOLI policies, less than 10%, use a corporate/institutional trustee to professionally manage a clients Irrevocable Life Insurance Trust (ILIT).[3] These trustees, unlike their unskilled counterparts, actively manage the policies entrusted to them as they are under the watchful eye of the O.C.C., which monitors the institutional trustees' activity on an annual basis.

Another strategy to obtain a greater degree of guidance from a professional trustee i.e., a trusted attorney or CPA, rather than one would receive from an amateur trustee, might be to enlist their services as a Trust Protector with various exculpatory clauses to limit their liability. Others might encourage a professional to act as a trustee by relieving them of various duties in order to reduce their trustee fees. It's however been my experience that reducing one's fees leaves the trust without anyone to make certain that the life insurance policy is properly managed and that it remains in effect. I would instead opt to educate the

[*] Henry Montag CFP, Managing Director of The TOLI Center East in practice since 1976 with offices in Long Island, NY, has authored articles and acted as a source for NYSBA, NYSSCPA, Bloomberg's Daily Tax Report, and the Estates Gifts & Trust Journal, Trusts & Estate Magazine, Accounting Today, and The Wall Street Journal. He has appeared as a guest on Wall Street Week, Fox Business News & News 12. He co-authored an American Bar Association Flagship publication, January 2017, titled; ''The Advisors' & Trustees' Guide to Managing Risk'' The January 2019 issue of Commerce Clearing House, referred to him as; ''One of today's best brains in life insurance.''

[1] Office of Comptroller of Currency (O.C.C.) (Aug. 2012).

[2] E. Randolph Whitelaw and Henry Montag, The Life Insurance Policy Crisis (Jan. 2018).

[3] E. Randolph Whitelaw and Henry Montag, The Life Insurance Policy Crisis (Jan. 2018).

trustee with written guidance rather than relieve them of their responsibilities or reduce their fees.

The other, 90% of TOLI policies, are managed by the grantors son or daughter, acting as unskilled trustees, that don't have the basic understanding that the policies they're responsible for are not guaranteed and that they require active management just like their stock/bond or real estate portfolios, otherwise their coverage will continue to expire prematurely as an increasing number already have. Most 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 aren't equipped to evaluate the risks, nor monitor the performance, they are unlikely to do what is necessary to remediate the underlying problems in the life insurance policy, to prevent it from expiring prematurely.

While the majority of life insurance policies responsible for the problems have typically been a flexible premium, non-guaranteed universal policy, the problem extends to variable and even whole life contracts that contain a blend of term insurance or are being paid for by borrowing from their cash value or relying on their dividends, which aren't guaranteed.

So how can the attorney/accountant, acting as trustee themselves or an adviser to the policy owner/ trustee know if the universal life policy they, or their clients hold have 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 death benefits using assumed interest crediting rates often made 20-plus years ago. 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 six to eight-page annual summary report sent to the insured, 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 inforce 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 on current mortality costs. A universal life policy is based upon an assumed interest crediting rate, while a variable universal life policy relies on the assumed subaccount yield. The difference between what was initially projected and what is currently needed will determine whether the current premium is sufficient to carry the policy to maturity or if it should be increased.

A survey in Trusts and Estates magazine, found that 83% of trustees had no guidelines or procedures for handling TOLI and 95% had no investment policy statement covering TOLI.[4] Additionally, only 28% of non- institutional trustees had reviewed TOLI within the last five years. Its been my experience that very little attention is being paid to over a trillion dollars of liquid, tax free, life insurance death benefits.

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 to keep the policy in force. Further, it will consider those premiums as a loan and charge a cumulative five percent interest rate on the loan each year. The trustee and the grantor are often unaware that this loan and the accruing interest on that loan is draining the policy's cash value, thus causing it to expire prematurely.

For the most part, my experience has shown 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 the insurance agent/broker may no longer be involved and that the insurance company, contrary to popular belief, is not obligated to make certain that your premium is sufficient to keep your policy in force. Nor is it in their interest that your coverage remains in force. The insurer after just eight years of an insured paying a premium stands to gain and after 20-plus years stands to gain substantially if your policy were to lapse, as it means that the insurance company keeps all the years of premium you've paid, without ever having to pay out a death benefit. Keep in mind that the insurance company is merely required to send out your premium notices and provide you with one annual statement, the management of the policy to make certain the premium is sufficient to maintain the death benefit to a desired age is 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), and an Adequate Funding Statement (AFS), outlining what's important to the grantor and a road map for the trustee to follow under normal circumstances as well as in the event of certain future contingencies. As a result of the backlash that has occurred, the insurance industry

[4] The Problem with Trusts Owning Life Insurance, Trusts & Est. Magazine (Apr. 2013).

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has begun to offer, ''No Lapse Guarantee Riders'' to universal contracts to help an insured prevent their coverage from expiring prematurely. However, these riders become null and void if the premium is paid, even a day late. Unfortunately not many people are aware of that option nor the associated pitfalls.

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, a son, or daughter of your client, retain the services of an independent non-biased third-party provider that will not only evaluate, monitor, and review their life contracts based on an Actuarial Evaluation Certification (AEC), but will also make suggestions based on current Uniform Prudent Investor Act (UPIA) which may uncover additional ways to take advantage of some positive remediation strategies.

This could most often include paying a higher premium for their existing contracts to guarantee that their contracts will not expire earlier than five years beyond normal life expectancy. They could decide to reduce the death benefit so that a smaller death benefit will remain intact. 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 several new benefits of life insurance as an ''Asset Class,'' some of which were previously unavailable. This could include the ability to pay for long-term care costs directly from the death benefit of the life policy, tax free. They could use the tax deferred accumulation aspects of a life insurance policy to supplement their retirement on a discriminatory basis and if set up correctly, make tax-free distributions through a series of loans and surrenders. 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 obtain several quotes 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 return upwards of 100% more than an insured would receive if they were to merely surrender the policy to the insurer for its stated cash value.

Lastly a trustee should make certain that premiums are properly and timely credited to the policy, and that all *Crummy* provisions are adhered to. They should also verify that insurance titling of ownership and beneficiaries is based on the insureds current objectives, 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 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 amateur trustee needs to be informed of the various problems and provided guidance regarding their fiduciary liability and responsibility to assure they do what's necessary to monitor and preserve the life insurance legacy they've been entrusted with. The most important questions in addition to inquiring how much life insurance is available, is to ask; How long is your current life insurance coverage guaranteed to last? When was the last time you checked?

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