# Trust Owned Life Insurance (TOLI)

**Handout materials are available for download or printing on the HANDOUT TAB on the gotowebinar console. There are TWO slide decks you should download.**

A KEY ESTATE PLANNING GUIDE

Law Easy

ChronicIllnessPlanning.org

# Trust Owned Life Insurance (TOLI)

## What Practitioners Need to Know

Martin M. Shenkman Henry Montag, and Richard (Dick) Weber

A KEY ESTATE PLANNING GUIDE

Law Easy

ChronicIllnessPlanning.org

# General Disclaimer

- The information and/or the materials provided as part of this program are intended and provided solely for informational and educational purposes. None of the information and/or materials provided as part of this power point or ancillary materials are intended to be, nor should they be construed to be the basis of any investment, legal, tax or other professional advice. Under no circumstances should the audio, power point or other materials be considered to be, or used as independent legal, tax, investment or other professional advice. The discussions are general in nature and not person specific. Laws vary by state and are subject to constant change. Economic developments could dramatically alter the illustrations or recommendations offered in the program or materials.

# Trust Owned Life Insurance (TOLI)

## Introduction and Key TOLI Issue

# Points of Discussion

- Types of life Insurance.
- How life Insurance was sold 20+ years ago.
- Effect of interest rates and inattention on TOLI.
- Advisors’ role and duration of coverage.
- Current trends and unknown problems.
- Strategies to stay clear of problems.

# TOLI Crisis

- Low interest rates over recent years, combined with neglect on the part of the private trustees, have resulted in an increasing number of non- guaranteed life insurance policies expiring prematurely.
- 23% of TOLI policies are projected to lapse prematurely.
- Premature lapse will undermine estate plans, harm those relying on the proceeds from those policies, and potentially trigger suits against trustees who have not managed TOLI properly.
- Policy replacements can be motivated for consumer-favorable and warranted benefits or to benefit the agent through incremental commissions. Be careful.

# TOLI Issues

- Policies often do not perform as suggested in policy illustrations when the policy was issued.
- Many policies have inadequate funding which may undermine the policy performance or even viability.
- The insurance company's financial position may have deteriorated since the policy was initially purchased.
- The cost of insurance may have changed since the policy was changed. For example, new mortality tables were issued in 2010.
- Insurance company investment returns, interest rate experience, and other factors changed since the policy projections were created before the purchase.
- Insurance companies are constantly developing improved products, if the TOLI is not monitored time may make the plan and insurance product obsolete or less than ideal for then current facts.

# TOLI Issues

- Life insurance policies are not self-managing – trustees or experts they hire must monitor and manage policies. Too many trustees mistakenly believe that a policy purchased at inception merely has to be retained.
- Insurance companies will not assuredly provide advance notice of policy problems to trustee owners of TOLI policies.
- Inadequately funded life policies can and do lapse.
- Unless Reviewed and Restructured 25-28% of universal life policies will expire early.
- 90% of ILIT policies are managed by non-professional individual’s not institutional or professional trustees.
- Approximately 40% of in-force non-guaranteed TOLI polices are carrier illustrated to lapse during the insured’s lifetime or within 5 years of estimated life expectancy.

## Mr. Smith Age 59 Purchasing $1,000,000 Life Ins Oct 1987

Agent. How much Ins Mr. Smith. $1,000,000

- Agent How long last Mr. Smith Age 95
- Agent What Interest rate Mr. Smith 9%

Premium needed for $1 mil to age 95 is $14,000

Application Signed Attny asked to set up Trust

No mention of :

Guarantee Time Period

Changing Interest rates strategy

- Policy requires active management

# Mr. Smith AGE 89 Oct 2017

## 30 Years Later

8-9% Assumed Interest rate not achieved

- 4.1 % Actual Interest rate achieved

Current $14,000 & Ins will expire 2017@ age 89

- Premium needed today to age 95 $26,000
- Current premium provides$450,000 to age 95

# OWNER'S/TRUSTEES ARE *NOT* MANAGING THEIR LIFE INSURANCE

*"I've written multiple stories over the past five years for the Wall Street Journal about the impact of low interest rates on universal life policies. The problem is exacerbated because many people underfunded their policies, often unaware of how important it was to keep them well-funde*

*Of the many consumers I've interviewed, most don't understand how the policies actually work. Many have lon since lost contact with the sales agents. I many consume response to the stories, as the problem is so recurring"*

–Leslie Scism Senior News Editor,
Money & Investment Section, *The Wall Street Journal*

# Insurance Industry‘s Posturing

**Life Agent Prime Responsibility is to Market**

**Insurer Duty Provide Policy/Annual Statement”**

**Encourages  Reliance On Original “As-Sold” Illustrations**

**Notice to policy holders of Problem is Not Sufficient**

**Currently Increasing COI’s first time  3 WSJ  2015 & 2016**

**Insurance Company Content with Current Situation**

**In Best Interest of Insurer  When Contract Expires**

# Annual Notice Important Statement

## Account Summary

*For an explanation of the terms used in this section, please refer to the page titled 'Definition of Terms'.*

| | | *Activity Since Last Statement* |
|---|---|---|
| Beginning Accumulation Value | $ | 8,813.17 |
| Premium Payments | $ | 0.00 |
| Policy and Administrative Charges | $ | -90.00 |
| Interest Credited | $ | 248.43 |
| Cost of Insurance Charges | $ | -3,134.05 |
| Rider Charges | $ | -0.00 |
| Partial Surrenders/Withdrawals | $ | -0.00 |
| Partial Surrender/Withdrawal Fees | $ | -0.00 |
| Other Adjustments/Charges | $ | 0.00 |
| Ending Accumulation Value | $ | 5,837.55 |

## Policy Values as of 04/09/17:

*For an explanation of the terms used in this section, please refer to the page titled 'Definition of Terms'.*

| | | |
|---|---|---|
| Accumulation Value | $ | 5,837.55 |
| Policy Loan Balance | $ | -0.00 |
| Adjustment if Surrendered | $ | -2,083.59 |
| Net Cash Surrender Value | $ | 3,753.96 |

## Interest Rates Credited

The effective declared annual interest rates credited to the unborrowed portion of the Accumulation Value were:

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Apr | 3.500% | May | 3.500% | Jun | 3.500% | Jul | 3.500% | Aug | 3.500% | Sep | 3.500% |
| Oct | 3.500% | Nov | 3.500% | Dec | 3.500% | Jan | 3.500% | Feb | 3.500% | Mar | 3.500% |

The declared annual interest rate is not guaranteed and is subject to change but will never be less than the guaranteed minimum annual interest rate of 3.000%.

## Important Notice

Changes in interest rates may impact the insurance coverage and cash value objectives of your policy. You may need to adjust your payment amount and/or death benefit to maintain your original objectives.

# Policy Considerations

- Flexible premiums good and bad points.
- Policy performance is 100% based on trustees action and in-actions.
- Premium based on current interest rates are not guaranteed.
- Duration of coverage is not guaranteed
- Primarily used for maximum death benefit - minimum premium.
- Omission of guarantee deficiencies.
- Policies must be reviewed and restructured.
- 23-25 % Universal Life policies are expiring early.
- Reduced interest rates and in-action.

# Policy Considerations

- Death benefit - Not guaranteed.
- Duration of contract - Not guaranteed.
- Premium - Not guaranteed.
- Cash values - Not guaranteed.
- Values based on stock market performance.
- Variable life must be reviewed for status annually.
- Good for overfunding and tax deferred growth.

# Term

- Time periods.
  - 1 -30 years, up to age 83 maximum.
- Entire time death benefit and premium guaranteed.
- Only 2% of term ever gets collected
- Uses for term.
  - Family income/college fund.
  - Mortgage or loan repayment.
  - Business buy sell.

# Case Study

- Mr. Smith, age 89, October 2016 29 years later
- 8-9% assumed interest rate not achieved.
- 4.1 % actual interest rate achieved.
- Current $14,000 and insurance will expire 2017@ age 89.
- Premium needed today to age 95  $26,000.
- Current premium provides $450,000 to age 95.

# Variable Life Insurance Risks.

- Cash value based on stock market performance.
- Cash values don't "lock in."
- Death benefit not guaranteed.
- Duration of contract not guaranteed.
- Premium not guaranteed.
- Indexed and variable life must be reviewed for status annually for sustainability.

# Role of Estate Planner

- Gathers all relevant data.
- Reviews client intentions.
- Discusses those named trustee, beneficiary
- Discusses administrative Crummey provisions.
- Discusses trustees role and duties.
- Does Not Discuss:
  - The Need for Owner/Trustee to Monitor, Review & Actively Manage
  - Grantor's Life Insurance Contract & Premium.

# Trustee's Role

- Fulfill their fiduciary duties in managing TOLI.
- Have fiduciary liability for maintaining trust assets.
- Attempt to minimize their liability exposure.
- Maintain good communication with client.
- Avoid any damage to organizations reputation.
- Familiar with  all available options, and benefits.
- In compliance with all OCC annual regulations.
- Outsource expert services needed for life insurance.
- Premiums raised over the years to cover to age 95.

# Options to Address Problems

- Pay a higher premium.
- Reduce face amount.
- Lengthen guaranteed duration of coverage.
- Obtain guaranteed new contract  if qualified.
- Life settlement.

## Transition to Richard Weber's Basic Slide Deck

- See separate slide deck then we will return to this PowerPoint.

# Trust Owned Life Insurance (TOLI)

## Cases Challenging TOLI Trustees

# Selected Cases - 1

- In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009).
  - First appellate ILIT case re  breach of fiduciary liability.
- French v. WACHOVIA BANK, NAT. ASS'N., 800 F. Supp. 2d 975 (D. Wis. 2011).
  - Analysis by bank proved action was in best interest of client, UPIA
- Estate of Schneider v. Finmann, 2010 NY Slip Op 05281 (June 17, 2010).
  - A personal representative of Estate may make a legal malpractice claim against an attorney.
- Paradee v. Paradee, 2010 WL 3959604 (Del. Ch. October 5, 2010).
  - Violation by Trustee of a duty trustee owes beneficiary is a breach of trust.

# Selected Cases - 2

- Larry Grill et. al. v. Lincoln National Life Insurance Company, 5:2014 cv 00051 S District court, California Central District(Riverside).
  - Beneficiary sue Lincoln National for withholding information regarding a life settlement.
  - Asserted that the Lincoln agent had a duty to review all potential options when the policy no longer became affordable, inclulding the possibility of a sale into the life settlement market.
  - An inherent conflict exists between insurance companies and their agents.
- Pearson v. Barr, 2002 WL 1970144 (Cal. Superior Court 2002).
  - Beneficiary sues CPA for failing to pay Life premium.

# Selected Cases - 3

- Rafert v. Meyer, N.W.2d, 209, 2015 WL 832590 (Neb. Feb. 27, 2015).
- This case held that a trustee has a non-waivable duty to keep beneficiaries informed about the status of life insurance policies held in trust (e.g. that the policy is in danger of lapsing), and a non-waivable duty to act in good faith and in the best interest of the beneficiaries.
  - Among the trustee's duties is the responsibility to inform the beneficiaries fully of all material facts so the beneficiaries can protect their own interests where necessary.
  - The trustee should treat a life Insurance policy as it would any other trust asset, that the trustee evaluate it and determine its appropriateness on a continuing basis, and that the trustee be paid for these services.
  - Relieving a trustee of various duties may result in lower trustee's fees, but it also leaves the trust without anyone to assure that the policy in question remains in effect, and that it is the correct policy for the trust, and that full advantage is being taken of its options.

# Selected Cases - 4

- Penman v. Penman, 2014 ONCA 83 (CanLII) [Penman] (This is a Canadian case, from Ontario).
- Dismissed the appeal of a trustee who was found liable for not making inquiries as to the performance of her co-trustee. Because she had abdicated her duties as a co-trustee, she could not avail herself of the protection afforded trustees by statute or the exculpatory clause in the trust instrument and the court found that she did not act reasonably.

# Trust Owned Life Insurance (TOLI)

## Role of Advisers

# Insurance Agents Are Often Not Involved

- Commission are generally earned upfront - 95% at initial sale, and about 5% for service.
- There is no incentive to service current policy/client.
- Agents/brokers do not continue to advise ILIT trustees for a variety of reasons. There are no dollar incentives for them to do so (see above). Many, perhaps 80-90% leave the insurance business.

# Attorney Role Generally Limited

- Gathers all relevant data to the estate/trust plan.
- Reviews client intentions when drafting documents.
- Discusses those named as trustee, beneficiary, etc.
- Discusses administrative provisions such as opening trust bank account, Crummey provisions, etc.
- Discusses trustees role and duties, but often this discussion is only with the client/insured/settlor and rarely does the trustee retain counsel.
- But clients rarely return for updates so changed goals often are not reflected in updates to the TOLI plan.
- Attorneys generally do not discuss the need to monitor insurance, review and actively manage life insurance contracts, etc.

# CPAs Role in TOLI Situations

- May confirm life insurance required for estate or financial plan.
- Might address cash flow available to pay premiums by gifts to trusts and annual gift exclusion/Crummey power planning.
- Prepares trust income tax returns and settlor's gift tax returns, but in most ILITs there are no returns as income is nominal and annual exclusion gifts are used to fund premiums. This is critical to understand as no returns means ILITs are "off-radar" for most CPAs.
- CPAs are also generally not involved in:
- Insurance policy performance evaluations.
- Monitoring the adequacy of premium payments to assure plan is likely to succeed.
- Annual monitoring of policies, trust administration, etc.

# ILIT Trustee Involvement

- Signs life insurance contract as owner in capacity as trustee.
- Generally unaware of assumed fiduciary liability and accepts policy selected by settlor/insured who generally have no expertise to evaluate the policy involved.
- Unaware of performance risk they might be assuming.
- Generally do not have skills to monitor, review and adjust premiums based on changing conditions.

# Trust Owned Life Insurance (TOLI)

## TOLI – Trustee Role/Duties

# Trustee Duties/Responsibilities

- Implement procedures that can be followed, and document actions.
- Adopt formal/written investment strategy to protect trust assets.
- Diversify the trust's assets to protect against loss, including consideration of multiple insurance policies from multiple carriers.
- Regularly monitor trust asset, the performance of those assets, and costs involved. This should include but not be limited to life insurance polices. The reality is that form many if not most ILITs there is often only a single life insurance policy and modest bank account as assets.
- Make changes as necessary to life insurance policies, and review all information annually.
- Retain advice of experts in areas the trustee does not have adequate skills.
- Make certain entire trust portfolio is in substantial compliance the prudent investor act.

# Trustee Duties/Responsibilities

- Obtain expert advice if trustee lacks the expertise.
- Determine whether to keep the existing policy in force or modify or replace it.
- Confirm, and if necessary update insurance beneficiary and ownership.
- Explore options to obtain new or additional policy benefits. Example – exercise conversion options.
- Evaluate contract and reduce unnecessary costs if feasible.
- Consider other insurance options to obtain a better value per dollar of premium.

# Trustee Duties/Responsibilities

- Private/individual ILIT trustees should follow same rules as the Institutional trustees and address the requirements of each of the following:
  - UPIA - Uniform Prudent Investor Act.
  - IPS - Investment Policy Statement.
  - IPE - Insurance Performance Evaluation.
  - AFS - Adequate Funding Statement.

# UPIA Requirements

- The UPIA requirements include:
  - The duty to incur only costs that are appropriate and reasonable.
  - The duty to set reasonable performance expectations.
  - The duty to exercise reasonable care, skill and caution.

# Prudent Investor Standards

- Implement good procedures that can be followed.
- Adopt formal investment strategy to protect trust assets.
- Diversify the trust's assets to protect against loss.
- Regularly monitor asset performance and reduce costs.
- Make changes as necessary and review all info annually.
- Retain advice of experts in areas they have no skill.
- Make certain entire trust portfolio in substantial compliance.

# Trust Owned Life Insurance (TOLI)

## Recommended Steps for ILIT Trustees

# Recommended Steps for ILIT Trustees - 1

- Meet before beginning to serve with a trust attorney and dissect the trust governing the trustee position to understand in specific terms what the trustee's rights, duties, obligations and so forth are. Annotating the trust to create a sort of Cliff Notes of the provisions governing trust operations can be quite useful. Meet again periodically to review communications, with and distributions to, beneficiaries.
- Meet at least twice a year with a CPA who has specific expertise in trust income tax planning to review year-end tax planning before the end of the year, and at another time during the year to review trust recordkeeping.
- 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.

# Recommended Steps for ILIT Trustees - 2

- Completing Crummey powers.
- Have an investment policy statement governing the trust.
- Poll trust beneficiaries to identify information relevant to the trustee making essential decisions. Identify current and likely future tax status of the beneficiaries.
- Inquire with some specificity as to the health status of the insured.
- Seek guidance as to the usefulness of a particular ILIT insurance plan in light of the dramatic actual and proposed changes in estate and income tax laws.

# Trust Owned Life Insurance (TOLI)

## Investment Policy Statement (IPS)

# IPS

- Every trustee should confirm the settlor/insured's goals for the ILIT and policies.
- Intent to provide update for specific beneficiary needs.
- Relative time frame for policy and plan.
- Risk tolerance for the policy.
- Planned gifting guidelines. How much does the settlor anticipate gifting each year to the trust? Does the increase in the estate tax exemption, possible repeal of state estate tax, and possible repeal of the estate tax on the federal level change this? Do financial issues of longevity planning for the settlor change this?
- Preference for restorative action if necessary.

# IPS considerations

- It is all about the process. It is not about guaranteeing a result or performance but about a process to reasonably address issues and options.
- Risk of liability to the ILIT trustee is high without a prudent process that is corroborated.
- Risk of liability is low if the trustee documents that a prudent process has been followed.
- Life Insurance must be treated as any other asset class.
- Implement good procedures that can be followed.

# Trust Owned Life Insurance (TOLI)

## Auditing TOLI

# What Are the Goals for TOLI and ILIT? - 1

- Why was the insurance purchased originally?
- What are the current goals and needs?
- What overall planning and financial circumstances exist now, and how have they changed?
- Consider lifestyle assets versus inheritance assets.  For example, the insurance may have been purchased with the possibility of accessing cash value.  This may no longer need to be an issue.
- Policies are issued today may have a different structure.
- This same person may no longer need cash value after retirement, instead he may just need insurance protection.

# What Are the Goals for TOLI and ILIT? - 2

- New policies have a very competitive price, build little cash value, but assure a death benefit. This person may be able to use this type of guaranteed death benefit policy. It is also known by other names: no-lapse guarantee, or secondary guarantee universal life.
- In this case you could replace the old policy by exchanging the cash value from the existing insurance in a 1035 (tax-free) exchange from the old policy to a new guaranteed policy.
- The new policy could be structured with premiums that are substantially less than they were before, or with an insurance face amount that is much greater for the same premiums. In some instances, no further premiums will have to be paid.

# Evaluate Funding Strategy

- Your funding strategy should be reviewed and monitored. The simplest approach is for an individual to pay premiums or for gifts to pay premiums.
- There may be more complex arrangements with a plan paying for the insurance, split dollar arrangements, and other techniques. If it's a second to die policy and one spouse dies, you lose half your annual exclusion gifts.
- Are there GST (Generation-Skipping Tax) implications are being triggered? What about repeal?

# TOLI Audit

- Mortality is the single most expensive portion of a life insurance policy.  Is there a similar policy that is less costly?
- Are there new or different insurance products that might take better advantage of industry advances? found that in 75% of cases, the person insured could have reduced their premium outlay by an average of 40%, or increased their coverage by an average of 40% for the same outlay.  These changes occur because insurance policies have evolved over time. Mortality rates have improved, people are living longer, and since insurance companies are going to pay claims later, newer policies will be cheaper than older policies even though the people insured are older.

# TOLI Audit

- What is the fair market value of the policy? Is the fair market value significantly higher in the secondary market than is the policy cash surrender value? If so is a sale advantageous?
- Obtain an in-force ledger. Independently verify that current policy projections and funding levels will keep the policy in-force to life expectancy.

# Adequate Funding Statement

- An "Adequate Funding Statement" defines the required premiums needed to guarantee policy is adequately funded to remain in force to specific desired age.
- It provides documentation demonstrating the trustee's prudent exercise of fiduciary power in event of future a future lawsuit.

# Policy Performance Evaluation

- A means of providing the grantor and trustee an objective evaluation of the TOLI policy.
- A means to examine the performance of current in-force coverage to identify potential areas of improvement and thereby prevent a premature lapse of the policy.
- This provides a means to compare the existing policy against other available contracts in the current market.
- An effective way to prevent unpleasant family disputes and avoid client dissatisfaction triggered by policy lapse.

# Policy Performance - 1

- Old variable insurance policies were sometimes sold with projections indicating rates of return that were never sustainable.  The underlying assets of the policy need to be considered.
- Other insurance policies are structured based on the insurance company's return, and not on the policies investment assets.
- Insurance companies invest primarily in high-grade bonds and mortgages.  As interest rates have fallen, the projections of most policies were not realized.  If the projections that were set when the policy was issued are not met, the policy may have to be funded differently either with greater premiums, or for a longer period of time.

# Policy Performance - 2

- It is also important to determine how the insurer credits earnings to a policy. Most insurance companies look at its overall portfolio return for the year and make a determination of what to credit to the policies.
- Interest rates may increase from 5% to 6%, but the insurance company may only have turned over and reinvested 10% of its portfolio.
- This illustrates a fundamental concept in crediting to insurance policies, that the policies' returns are sensitive to returns in the market, but with a lag due to the turnover factor. They follow the market both when returns are going down as well as when they are going up.

# Status of the Insurance Company

- If the life insurance company doesn't survive, the initial projections may be irrelevant.
- When Mutual Benefit went under, policyholders received coverage so that they were protected, but the economic arrangements of those policies were quite different.
- A.M. Best, Moody's, Duff and Phelps, Standard and Poor's and Weiss all rate insurance companies.
- Vendors can provide an analysis of the financials and report all agency ratings for an insurance company.

# Trust Owned Life Insurance (TOLI)

## Policies in Jeapardy

# What To Do With Failing Policies

- When the policy has not been appropriately managed by the private owner or trustee, corrective action involving these options is available to them:
  - Increase the premium to maintain the death benefit to a desired age.
  - Reduce the death benefit.
  - Attempt to exchange to a more competitive policy.
  - Consider a "life settlement," a sale at a higher valuation than the cash value.
  - A combination of all or some of the above.

# Dealing with Today’s Facts
## In Summary

What Was Good Then May Not Be Good Today!

- Contract Performance  Needs to be Examined
- May or May No Longer Need Life Ins today
- May Want Income Stream  or LTCI
- May Want a Unique Exit Strategy i.e. Life Settlement
- Need Credible Independent Suitable Advice

**Make Best Use of What You Have Today**
BY COMPARING TO WHATS AVAILABLE  **TODAY**

# Trust Owned Life Insurance (TOLI)

Assemble Policy/TOLI/ILIT File

# Items to include in File - 1

- A signed copy of the trust agreement.
- A policy contract and signed copy of the "as sold' delivery illustration.
- A current Trust Investment Policy Statement.
- A Grantor Guidance Letter providing guidance at time of policy issue concerning policy purpose and long-term performance expectations.
- Product suitability evaluation signed by writing agent when purchased.
- Performance monitoring reports.

# Items to include in File - 2

- Beneficiary communication if appropriate (e.g., is it a quiet trust, has a protector or other person been designated to receive reports?).
- Any documentation evidencing legal actions taken by the trustee under the terms of the trust during the years the trust was administered (or corroboration that there were none).
- Copies of any disbursements from the trust and back up for them (legal fees, accounting fees, etc.). If none, who paid the accounting fees for tax preparation?

# Items to include in File - 3

- Any contractual agreements (e.g. hiring insurance or investment experts, attorney retainer agreements, engagement letter with CPA firm, etc.), any other investment actions taken by the trustee, e.g. signing an investment policy statement for the trust investments (or corroboration that there were none).
- Crummey powers supporting gifts to the trust. Waivers of annual demand powers if any.
- Gift tax return reporting gifts to the trust. Was GST exemption allocated (intentionally or by the automatic allocation rules) to the trust?
- Income tax returns if any have been filed. Any information on tax elections or decisions? Any other permanent documentation?

# Trust Owned Life Insurance (TOLI)

## ILIT Considerations

# Introduction to Irrevocable Life Insurance Trusts (ILITs)

- The ILIT has traditionally been used as the owner and beneficiary of life insurance in order to:
  - Remove the proceeds of the policies from the insured's estate.
  - Protect the growing cash value from grantor's claimants.
  - Protect the death benefits from the heir's claimants or possible divorce.
  - Prevent the intended heirs from squandering the money.
- The new high federal estate tax exemption is being viewed by many practitioners as a reason to skip ILITs and to terminate existing ILITs. The threat of repeal and if repeal occurs, the pressure will increase. That will often be to the client's detriment. ILITs are not obsolete, they must just be adapted to the new planning environment.
- Consider how you can adapt traditional ILIT/insurance planning to help clients in the new tax environment..

# Transfer for Value Considerations

- Transfer for Value Considerations:
  - Clients tempted to liquidate family limited partnerships (FLPs) or limited liability companies (LLCs) because the discounts they afforded may not only be no longer relevant, should consider their use to avoid the transfer for value rules that can affect life insurance if clients decide to change the ownership of large insurance policies as part of their post-ATRA restructuring.
  - There have been proposals to modify or restrict the transfer for value rules, which could adversely affect this benefit. And even without any changes, the current transfer for value rules can present income traps for the unwary.

# Insurance – Enhanced Value of Tax Free Build Up - 1

- The most significant benefit of permanent life insurance, the relative advantage of which was enhanced by the increased income tax rates and the Medicare tax on passive investment, is the tax free build up inside of the policy.
- The excess of cash value above basis isn't subject to income tax unless:
  - The policy is characterized as a modified endowment contract (MEC).
  - The policy is surrendered and withdrawals exceed the client's tax basis in the policy.
- The client can avoid income tax when withdrawing money from the policy if the withdrawals are limited to the income tax basis in the policy, and thereafter cash is withdrawn as loans taken out for the excess above basis.

# Insurance – Enhanced Value of Tax Free Build Up - 2

- The long-term returns on a properly structured traditional cash value life insurance policy may be viewed as attractive.
- Life insurance companies, by law, are required to keep substantial reserves. The reserves are low risk. The average life insurance company has more than 50 percent of its assets in high-quality bonds.
- The tax advantages of life insurance and the risk-averse nature of the insurance companies investments, insurance as a conservative investment may appeal to more clients. However, if current proposals to reduce income tax rates and repeal estate and GST tax are enacted these benefits may be reduced or obviated.

# Insurance Leverage Remains Valuable

- Life insurance also supplies leverage that can be used to further enhance planning. Insurance leverage can come in a number of forms:
  - Annual premiums that are typically paid are a very small fraction of the death benefit most policies afford (but as explained below, many new ILITs will have other assets generating cash flow to pay premiums instead of relying on annual gifts).
  - The death benefit is paid in full regardless of how many or how few premiums have been paid prior to death (leaving aside an issue of contestability).
  - If life insurance is owned by an irrevocable life insurance trust (ILIT), the death benefits can be kept outside of the transfer tax system. Even if transfer taxes are not a concern, creditor protection, management of assets as beneficiaries age (e.g., Alzheimer's risk) etc. will almost assuredly be important.

# Insurance Leverage Remains Valuable

- Life insurance also supplies leverage that can be used to further enhance planning. Insurance leverage can come in a number of forms:
  - Only cash or property gifted to the ILIT is subject to gift (and possibly GST) tax. For wealthy clients this is valuable but may be obviated by proposed tax law changes.
  - With the substantial inflation adjusted exemption amounts, there will be no gift (or GST) tax concerns for the vast majority of wealthy taxpayers. (Connecticut residents may be an exception because of the state gift tax.) This can simplify planning to transfer assets to fund premium payments to ILITs, eliminating a barrier that had been significant in prior years to holding insurance in ILIT format. The gift tax has not been proposed for repeal.
  - There are other special rules allowing for greater leverage, e.g., split-dollar planning.

# Revise ILIT/Insurance Planning

- Review all existing insurance plans, ILITs, and coverage.
- A 1035 exchange of a policy that no longer serves the client's needs for a new policy may provide the desired flexibility.
- Even irrevocable trusts may be modified by fiduciary actions (e.g. powers given to trustees or trust protectors).
- More trusts have trust protectors who may have powers to change the ILIT.
- Decanting to improve the ILIT plan has grown in popularity with more than 20 states adopting decanting statutes. Delaware and other states permit modification by non-judicial agreement.

# Insurance SLAT Mortality Risks - 1

- Define SLATs – spousal lifetime access trusts.
- Non-reciprocal SLATs where H creates for W and W creates somewhat different SLAT for H.
- This technique has been used to take advantage of the high gift tax exemption yet assure that the non-grantor spouse still has access to the income and capital for themselves.
- Non-reciprocal SLATs remain a great planning tool for moderate wealth clients for tax and asset protection. SLATs were commonly used in the 2012 gift stampeded as clients sought to capture what might have been a large gift exemption with a short perceived half-life.

# Insurance SLAT Mortality Risks - 2

- While the beneficiary spouse is alive, the grantor spouse might indirectly benefit through distributions or purchases of personal property for the beneficiary spouse. Obviously, care has to be taken in such circumstances to avoid the implication of an implied agreed or direct access that would expose the SLAT to creditors of the grantor spouse and also thereby make it included in the grantor spouse's estate.
- Grantor spouses of a SLAT face the risk that when the beneficiary spouse dies, the indirect access by the surviving grantor spouse of SLAT assets is lost.
- Use life insurance to insure the risk of the beneficiary spouse dying first or prematurely (e.g., before the couple has accumulated adequate retirement assets to support the surviving spouse even without assets of the SLAT for which the first to die spouse was beneficiary).
- **Example**: W creates SLAT for H with $2 million. H creates SLAT for W with $1.5 million. If H dies W no longer has access to the $2 million in the SLAT she created for H. So have the SLAT H created for W buy $2 million of life insurance on H so W will have access to the same pool of dollars if H dies.

# Conclusion and Additional Information

# Conclusion

- TOLI risks and issues are significant and affect many clients and many ILITs.
- Practitioners should be proactive to educate clients, who may be preoccupied with the potential for estate tax repeal, to focus on these issues.

# Additional information

- Martin M. Shenkman shenkman@shenkmanlaw.com
- Henry Montag henry@thetolicentereast.com
- Richard (Dick) Weber dick@ethicaledge.biz

# DISCOUNT FLYER For ABA Book