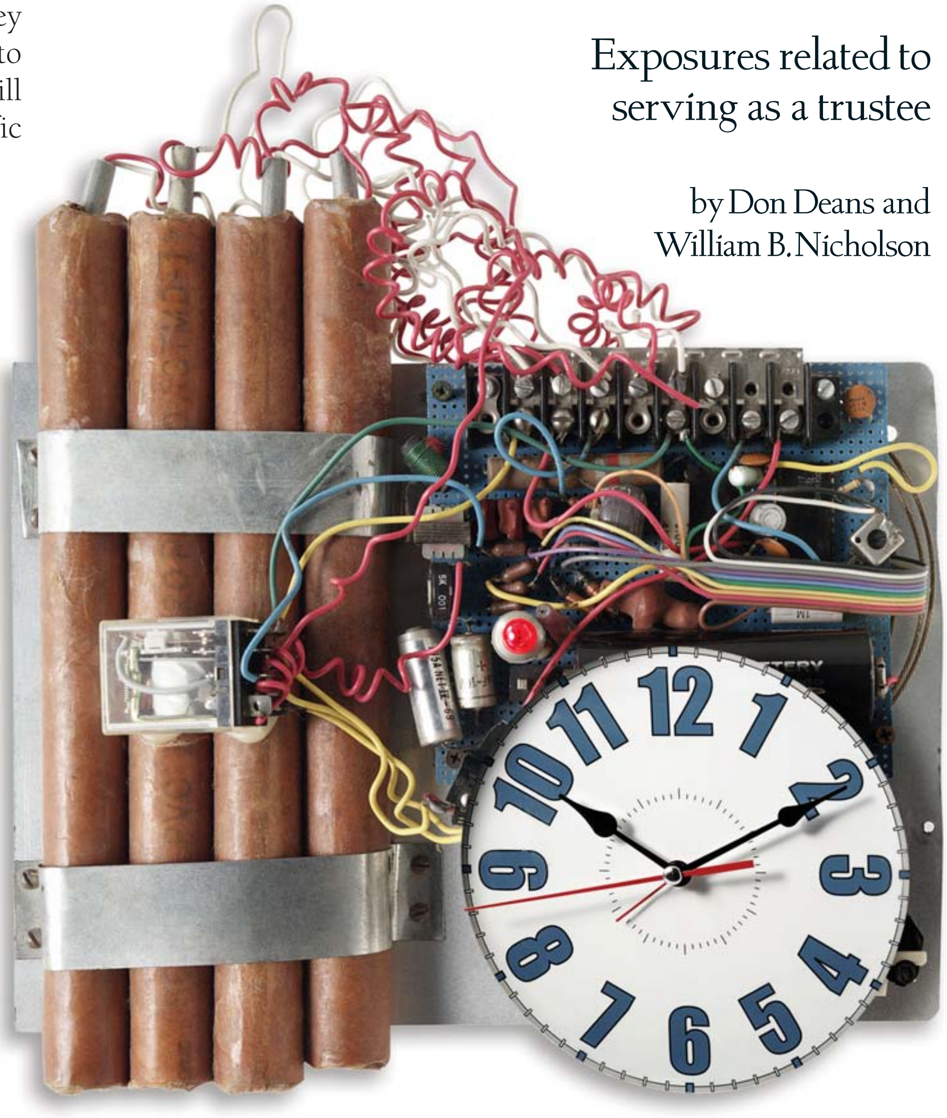
Trust-Owned Life Insurance: The CPA's Role

Exposures related to serving as a trustee

by Don Deans and William B. Nicholson

Many CPAs recommend that their high-net-worth clients use trust-owned life insurance (TOLI) as the cornerstone of their estate plan. In addition, many CPAs choose to serve as trustees of such trusts. CPAs who are considering accepting a trustee designation should be well aware of the hazards inherent to the task and make sure they have the skills and knowledge to take on the challenge, which will usually involve some specific training in life insurance.



Even if they shun this weighty responsibility, CPAs can still serve critical client needs in this area. This article is designed to help CPAs decide whether to accept the trustee designation. If they do accept it or are already a trustee, they can assess their approach against fiduciary requirements and best practices. With the passage of the Uniform Prudent Investor Act in the mid-1990s, trustees' fiduciary duties are held to a higher standard than under previous law. Many of those practices, however, also apply to life insurance generally, whether or not a trust is involved.

As trusted advisers, CPAs have an obligation to educate their clients about the pending crisis in TOLI. A real problem looms on the horizon. Certain studies have shown that more than 25% of nonguaranteed flexible TOLI policies will lapse during the insured's lifetime ("TOLI Risk Management at Litigation Crossroads," *Steve Leimberg's Estate Planning Email Newsletter*, no. 1110, April 12, 2007). You should take the opportunity to work with a competent insurance professional to protect your clients' plans and assist your clients in developing a best-practices review for their TOLI.

In many cases, CPAs can best serve their clients by assisting them with obtaining a competent corporate fiduciary, or trust company, to serve as trustee. CPAs should also advise clients against choosing as the trustee a family member who knows nothing about life insurance.

Ed Linsley, senior vice president and manager of personal trust at Reliance Trust Co., recommends evaluating a trust company by how long it has been in business, how much in assets it manages, whether it has local representation to serve the client, and whether its fees are reasonable. Also, inquire whether the trust company does business in irrevocable life insurance trusts (ILITs). If so, how many trusts does it administer and does it audit them?

THE POLICY

Permanent life insurance policies sold over the last 25 years have typically been whole life or flexible premium nonguaranteed policies (universal, variable universal and adjustable life products) or a blend of each with term insurance. Whole life contracts provide for a guaranteed fixed premium, death benefit and cash surrender value. Universal and adjustable life policies are sensitive to the short-term credit rates offered by the insurance carrier, while variable life policies are invested in mutual fund-like subaccounts. Flexible premium insurance contracts provide limited guarantees while affording the policyholder flexibility as to the amount and timing of premium payments. Unless they are funded properly and sufficiently and actively managed, the flexible products run the risk of terminating with no value and no death benefit.

When the investment subaccount or interest rates rise or remain relatively constant as compared to the illustrated rate, flexible contracts tend to perform reasonably well. However, in recent years, interest rates have fallen sharply and are significantly lower than the interest rates illustrated when many of these policies were purchased. Similar results occurred for variable policies after the stock market downturn from 2000 to 2002. Consequently, many of these policies are in danger of lapsing.

Let us consider the fate of a variable universal policy issued in 1999, for example. The Standard & Poor's 500 index took more than six years (79 months) to regain its value from August 2000 to May 2007. If the premiums were not increased to reflect the market losses, the policy might have been in serious trouble. Likewise, for a universal life policy issued in the early 1980s, the premium was calculated with an annual assumed interest rate of about 14%. The rate today is 4%. Accordingly, if the premium were not increased substantially, the policy would have lapsed. Additionally, most flexible premium policy illustrations are calculated with the highest interest rate and lowest premium allowed. This may increase sales but does not help prevent policy lapses.

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THE ILLUSTRATION

How is the policy owner—or a CPA trustee or adviser to the policy owner—to know if the policy has issues? The original illustration is generally of no help. Life insurance illustrations are simply computer printouts that show various aspects of the policy such as premiums, cash values and death benefits under interest crediting rate assumptions. The insurance company is not required to meet these estimates. The only certainty about illustrated values is that the policy's actual performance will differ from them as markets change.

Sometimes the annual policy statement contains footnotes that can highlight a problem. Generally, however, the only way to know how a policy is performing is to order an in-force reprojection. The in-force reprojection is a re-illustration of the policy from the present as a projection of values into the future based on current mortality costs. For a universal life policy, it includes an assumed interest crediting rate or, for a variable universal life policy, the assumed subaccount yield. It will determine whether the current premium is sufficient to carry the policy to maturity or should be increased. This should be requested and analyzed annually.

THE TRUST

In many cases, the agent never sees the insured after policy delivery. The policyholder, not understanding insurance illustrations

EXECUTIVE SUMMARY

■ **CPAs with specific training and understanding of life insurance in estate planning sometimes are trustees** of trust-owned life insurance (TOLI). With the complexity of many policies, responsibilities of annual policy review and fiduciary duties under the Uniform Prudent Investor Act, however, many may decide to serve their clients by helping them select a trust company to handle TOLI management and then continue to advise the grantor and monitor the trust's performance.

■ **Whether the trustee is a CPA or other professional**, the trustee should ensure premiums are sufficient to cover any decrease in interest rate for universal life policies or investment subaccount results for variable universal life. Shortfalls may result in a loan that in the case of a policy lapse could cause cancellation-of-debt taxable income to the client.

■ **The annual policy review should also check for** proper crediting of premiums and titling of ownership and beneficiaries, and evaluate the performance of the insurance carrier and the policy, using an in-force reprojection. If the policy is under-performing, options may include replacing the policy or selling it in a life settlement.

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and how policies work, oftentimes files the policy away in a lockbox—as if it were guaranteed. In the case of a lapsing policy with a loan, the policy owner can even become subject to income tax due to the forgiveness of debt. 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 and then count those premiums as a loan. The trustee and the grantor may be unaware of this loan and consequently unaware of the accruing interest on that loan as well.

In the estate-planning arena, where the use of TOLI is prevalent, life insurance is often used to provide sufficient liquidity to fund estate taxes and final expenses. Trustees—even CPAs—of ILITs typically are not skilled life insurance specialists and do not recognize that a life insurance contract is a complicated financial instrument. Many trustees do nothing more than pay premiums and send out the Crummey notices. (Crummey notices give beneficiaries the option of demanding withdrawal of gifts to the trust before the gifts become the property of the trust. Without Crummey powers, the donor to the trust risks losing the annual gift tax exclusion.)

A recent study in the *Journal of Financial Service Professionals* ("Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make," July 2005, page 39) indicates that anywhere from 70% to 95% of TOLI had no servicing agent. A survey in *Trusts and Estates* found that 83.5% of professional trustees had no guidelines or procedures for handling TOLI and 95.3% had no investment policy statement covering TOLI ("The Problem With Trusts Owning Life Insurance," May 2003, page 62). Additionally, only 28.8% of nonprofessional trustees had reviewed TOLI within the last five years.

Thus, the problem is that the trustees have neither the life insurance skills to manage TOLI, nor the procedures in place to do so. Exacerbating the problem is that the insurance agent is no longer involved.

THE REGULATIONS

Further compounding the task facing trustees is the legislative action involving the Uniform Prudent Investor Act (UPIA). The National Conference of Commissioners on Uniform State Laws drafted the UPIA as a model act in 1994 (see "Put Your Trust in Trustees," *JofA*, Nov. 98, page 69). It has been in force in various forms in the majority of states since then. This act holds a trustee to a higher level of conduct and provides means to enforce those standards. The trustee must act in a fiduciary capacity to achieve the objectives stated in the trust.

Additionally, the UPIA implies that life insurance should be treated as an asset class. This requires the trustee to monitor the quality of assets given to the trust and to assess the risk tolerance of the trust. A CPA who is not a trustee can double-check to make sure the trustee is performing those duties. If the trustee is a family member, then it's all the more advisable for the CPA to play a more active role, by advising the family trustee.

In short, life insurance policies are complex financial investments. Life insurance expertise among trustees is limited, and regulations involving TOLI have become more rigorous. The question now becomes, how do I assist my clients with their TOLI? Here is the silver lining—the complexity provides an opportunity for additional services to your clients.

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TRUST INVESTMENT POLICY STATEMENT

Every grantor with a TOLI needs to have an actively managed, dynamic review process. The trustee must have a documented process for TOLI reviews. The review should begin with a trust investment policy statement (TIPS). Only 4.7% of TOLI has such a policy statement (see "The Problem With Trusts Owning Life Insurance," cited above). The TIPS should provide a road map for managing the policy. Goals and objectives should be established, the criteria for the selection and/or replacement of the insurance carrier should be included, and an action plan for policy evaluation should be delineated.

The TIPS should also spell out what to do if a policy fails to perform. This document provides the foundation for the trustee's responsibilities.

THE POLICY REVIEW

For CPAs who are trustees of TOLI, we feel that the trust should be reviewed annually to protect grantors from unforeseen changes and to protect CPAs from legal exposure resulting from changes in the original scenario. This review should include the following steps:

Administrative review. Ensure that premiums are properly and timely credited to the policy; check for errors that may have been made by the insurance company; and verify that insurance titling (ownership and beneficiaries) is correct.

Insurance carrier review. The insurance carrier's financial integrity should be evaluated. Economic circumstances confirmed by rating agencies may provide a higher level of risk than the TIPS allows.

Policy performance review. The trustee must consider many factors. At a minimum, the trustee should order an in-force illustration from the insurance carrier. The in-force reprojection allows the trustee to determine how the policy might perform based upon current facts rather than the original illustration. The policy should then be sensitivity tested using various assumptions to determine how it might perform with different economic variables.

Obviously, a variable life policy should also be reviewed in terms of subaccount performance and risk. The trustee should consider hiring a money manager to monitor the investments within the policy.

At this juncture, the trustee should have enough data to determine if the policy is performing under the TIPS. If it is performing, then document your procedures and perform the review next year. If it is not performing, the trustee should consider remediation.

Optimization review. Optimization may vary from negotiating with the current insurance carrier to replacing the insurance policy, to selling the policy in a life settlement. Facts in each situation will vary based upon the insured's health and economic situation.

Negotiation with the current carrier might include having the carrier lower mortality rates based upon current mortality tables, reducing the death benefits or adjusting premium payments.

If the insured's health has not changed appreciably, the trustee should shop the policy. There have been changes in mortality, underwriting and policy design whereby the insured may obtain a new policy with the same or improved death benefit at substantially lower cost. One study indicated that there was a 75% chance that with no increase in premiums, a policy's face amount could be increased 40% or more through the acquisition of a new policy (*American Banker*, vol. 163, no. 22, page 17, Feb. 3, 1998). The insurance industry is constantly evolving, with new products containing new guarantees and riders.

If the insured's economic or life circumstances have changed, explore a sale of the policy in the life settlement market. This process should be considered when the purpose of the trust has become obsolete and the fair value of the policy exceeds any other benefit.

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A Firm Foundation

These suggestions will enable you to not only solidify your relationship with your high-net-worth clients, but will allow you to market this relationship to other high-net-worth clients.

Life insurance is frequently the bedrock upon which a client's financial estate plan is built. We recommend that, if your clients have nonguaranteed flexible policies that are more than 10 years old, you and your insurance professional contact them to begin a best-practices review. You need to ensure that their foundation is not on shifting sand. ❖

AICPA RESOURCES

JofA articles

- "Turn Unneeded Policies Into Cash," Sept. 05, page 39
- "Understanding Life Insurance Illustrations," Feb. 03, page 70
- "Put Your Trust in Trustees," Nov. 98, page 69

Publications

- *The New Fiduciary Standard: The 27 Prudent Investment Practices for Financial Advisers, Trustees, and Plan Sponsors* (#017242)
- *The Adviser's Guide to the Revised Trust Accounting Rules* (#061073PDF)

For more information or to make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

OTHER RESOURCES

Web site

Uniform Prudent Investor Act, **www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf**