Life Insurance for Estate Planning

By Ben Baldwin

Some years ago I posed a general question to the members of the CCH Financial and Estate Planning Advisory Board. The question was, "Why is life insurance apparently the third rail of estate planning?" The answer was a resounding, "It's the commissions." Today, in spite of the fact that it is not generally known, there is an increasing supply of no-commission, no-surrender charge, and fiduciary-friendly life insurance products.

This sea change in the life insurance world is likely to cause estate planning professionals and fiduciaries to take another look at life insurance as a financial tool capable of leveraging trust assets, reducing risk, expense and income taxes within a trust, consistent with the provisions in the trust.

A trustee considering a life insurance strategy would look first to the terms and objectives of the trust and the best interests of all current and potential beneficiaries and then to the tenants of the Uniform Prudent Investor Act, as adopted by the State of jurisdiction. Excerpts from the Uniform Prudent Investor Act as approved by the American Bar Association February 14, 1995 may provide a reasonable check list for a fiduciary contemplating a life insurance strategy for a credit shelter trust.

Uniform Prudent Investor Act

SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated, not in isolation, but in the context of the trust portfolio as a whole, and as a part of an overall investment strategy, having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its\ beneficiaries:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely-held enterprises, tangible and

intangible personal property, and real property;
(5) the expected total return from income and the appreciation of capital;
(6) other resources of the beneficiaries;
(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the trust, or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

SECTION 3. DIVERSIFICATION.

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.[1]

The Uniform Prudent Investor Act as a Check List for Life Insurance

The first three Sections of the Uniform Prudent Investor Act (as presented in the Side Bar) provide a virtual check list as our guide for evaluating a life insurance policy strategy for a particular trust. The following are the trustee's hypothetical answers to the questions implied by Sections 1, 2 and 3.

Section 1. Prudent Investor Rule.

1. This state of jurisdiction has adopted the Uniform Prudent Investor Act and it is applicable to this trust.
2. No part of the Uniform Prudent Investor Act, as adopted by the State of jurisdiction, has been expanded, restricted, eliminated or otherwise altered by the provisions of this trust.

Section 2. Standard of Care; Portfolio Strategy; Risk and Return Objectives.

(a) The Stated Purpose of the Trust:
Article Five, paragraph 5.01 of the trust referring to Trust B, the credit shelter trust, states in part that ". . . the trustee shall not invade the principal of Trust B for the support and maintenance of my said wife unless readily marketable assets of Trust A have been completely exhausted."

Currently there is no indication that the readily marketable assets of Trust A will be exhausted and, as a result, it is expected that the credit shelter trust assets will constitute the legacy of the primary beneficiary.

(b) Current credit shelter trust investments are in a carefully diversified and monitored portfolio of approximately 65 percent equity, 35 percent bond/interest investments, with an overall objective of long-term growth, with an estimated time period of twenty-five plus years, due to the surviving spouse's good health and family longevity.

Advantages of the Current Credit Shelter Trust Portfolio

(i) Diversification and monitoring has managed risk and provided excellent risk-adjusted returns, suited to the stated trust objectives.

(ii) Trust expenses are monitored, transparent and competitive based upon the services provided.

Disadvantages of the Current Credit Shelter Trust Portfolio

(i) Portfolio income and gains, not being distributed to the beneficiary/ies, is subject to income tax at high federal and state trust tax rates. Over the years, the cost of this trust taxation has reduced the net after-expense rate of return by an average of _____% per year. (See CPA statement attached)

(ii) The growth of the credit shelter trust assets will not get a step-up in cost-basis at the surviving spouse's eventual death which is expected to leave the beneficiaries of the legacy with a substantial income tax liability. This is not consistent with the trust objectives.

To Be Determined

(i) Can a life insurance strategy match the current trust diversification with credible, transparent and competitive costs?

(ii) Can the life insurance strategy mitigate the current income tax expense of the trust?

(iii) Can the life insurance strategy provide a step-up in cost-basis at the surviving spouse's eventual death?

(iv) Exactly what is the cost of the risk management feature of life insurance that assures a legacy even if the surviving spouse should die during a bear market?

(c) Considerations:

(1) General Economic Conditions

Both market and regulatory conditions favor diversified investing consistent with the state-adopted UPIA and consistent with this trust's objectives.

(2) Inflation or Deflation

Inflation is considered to be a greater risk than deflation for the expected duration of this trust. The diversified investments of this trust address this risk.

(3) Tax Consequences of Investment Decisions/Strategies
The current portfolio is experiencing trust bracket taxation of income and realized gains. Rebalancing, asset allocation and trading all have negative income tax consequences to the trust under the current non-life insurance strategy.

(4) Constraints of Unique Trust Assets
The assets of this trust are all marketable securities at the present time.

(5) Expected Total Return and Appreciation of Capital
The target total return and historical long-term total return of this trust has been between 6 percent and 7 percent, net of expenses and taxes.

(6) Other Resources of the Beneficiaries
All beneficiaries currently have adequate current resources so that no calls for assets in the credit shelter have been made, or are expected to be made.

(7) Liquidity, Regularity of Income, Preservation or Appreciation
Currently liquidity and regularity of income are not constraints of this trust. The long-term objective of the trust is capital appreciation.

(8) "Special" Trust Assets
No special assets are in this trust.

(d) Verification of Facts
The above check list has been reviewed by all advisors and beneficiaries involved and confirmed to be accurate.

(e) Trustee Empowered to Invest in any Kind of Property
A life insurance strategy is allowable under the UPIA, as adopted by the State of jurisdiction and there are no provisions of the trust limiting such a strategy.

(f) Trustee Skills
The trustee is using experienced, fee-only life insurance experts to present the details of a fiduciary-friendly, no-commission, no-surrender charge, transparent life insurance policy strategy for the trust, at an acceptable fee.

Section 3. Diversification.

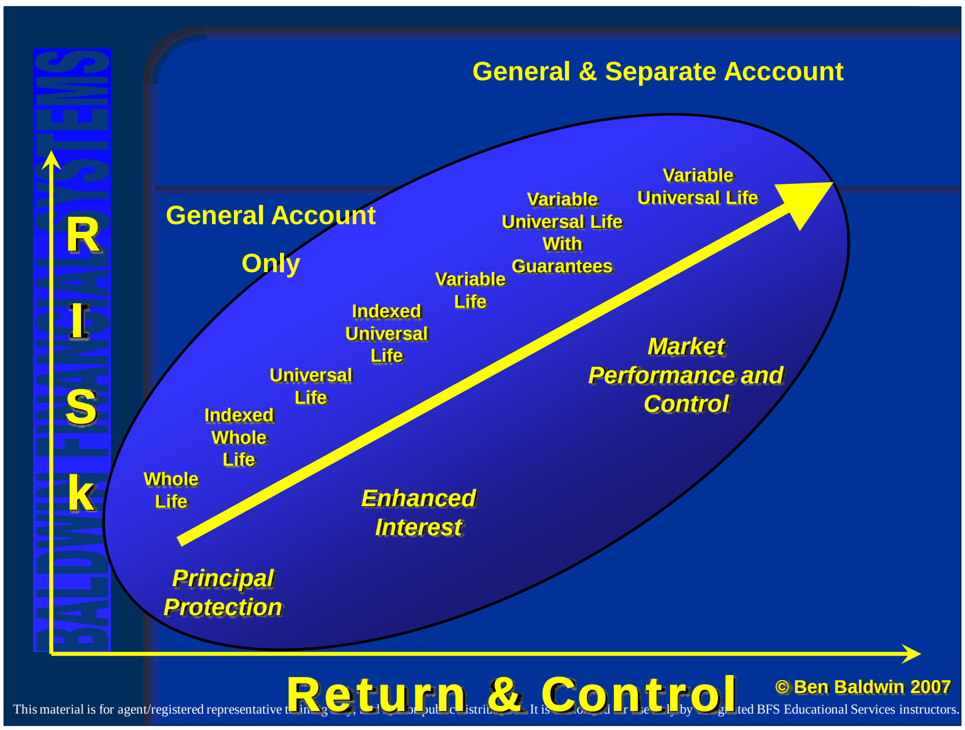
There are no special circumstances of this trust or the trust beneficiaries that require the Trustee to ignore the Trustee's duty to diversify.

Fiduciary-Friendly Life Insurance Selection

This particular trust seems to be a candidate for a life insurance strategy. The question to be determined is which investment-related life insurance policy design is appropriate for the purposes of this trust.

Any investment-related life insurance policy can be used to hold capital that can then be used for any purpose. The life insurance advantage is that the capital accumulates income tax-free and can be accessed without incurring income taxes. The tax-free earnings can be used to pay for the *pure protection* element of the "investment-related" life insurance contract. Withdrawals, from life insurance policies that allow withdrawals, are tax-free cost basis first, referred to as FIFO for first-in-first-out, and only after that is any gain withdrawn subject to ordinary income tax. Policy loans using life insurance assets as collateral are not subject to income tax unless, and until, the policy is surrendered during the insured's lifetime.

So which investment-related life insurance policy design is least likely to cause concern for the fiduciary of a trust?



Five Life Insurance Myths That Can Cause Trust Unsuitable Life Insurance Selection

1. <u>Guarantees Reduce Risk</u>

   There are no guarantees, only guarantors. Reliance on guarantees is reliance on others. Reliance on guarantees is reliance on systematic, un-diversifiable risk. Guarantees are given at contract inception and continue throughout the contract duration during which the circumstances of the guarantor will change. Guarantees come with contractual requirements to maintain the guarantee. The trustee may find it difficult or inconvenient to comply with some of the requirements to maintain these guarantees. Life insurance companies who provided guarantees have failed, causing angst for grantor, beneficiary and the fiduciary.

Guaranteed ongoing premium obligations can be a constraint rather than a benefit as a result of the consequences of missing a required premium.

Guaranteed death benefits are not necessary in transparent life insurance policies. The trustee can see the current costs of the policy and merely needs to make sure that sufficient resources are available within the contract to meet these interior costs to assure that the policy will stay in force.

2. Premium Equals Cost

In *pure protection* insurance contracts, such as auto, homeowners, liability and pure-protection life insurance, premium generally does equal cost. However, when the word premium is applied to any of the *investment-related* life insurance contracts, it is implied that the higher premium equals higher cost. Poor life insurance decisions can result if thinking stops at this point. If one is to have fiduciary responsibility for life insurance, it is essential to understand the real costs and benefits of *pure protection* and *investment-related* life insurance selections.

3. Life Insurance Gets You Life Insurance Company Money at a Discount!

Hold it now . . . that is not a myth! That is 100 percent true if the insured dies when the death benefit is substantially made up of the insurance company's amount at risk, as opposed to the policy owner's investment capital. That is a valuable benefit of life insurance risk management.

But, we must recognize that the insureds of trustee life insurance policies are likely to live a long time and are intent upon leaving the largest legacy possible. The fiduciary responsible for those life insurance policies knows that the largest legacy possible for those long living insureds is more likely to be realized by reducing the insurance company *amount at risk* as soon as possible in order to reduce the cost of insurance (COIs), and expenses being imposed on the life insurance capital. This strategy minimizes the drag of the monthly deductions for COIs and expenses on the capital and allows the income tax-free compounding of returns to increase in value during the long lifetime of the insured to provide the greatest legacy possible. The traditional whole life policy design does this by contract with the guaranteed cash value equaling the face amount by the insured's age 100. The insurance company has reduced its amount at risk over the duration of the contract. By the time statistical life expectancy has been reached, the insurance company amount at risk has been reduced to a negligible amount and the death benefit substantially is policy owner money.

Thus, a life insurance fiduciary should monitor the amount at risk and the exact monthly deductions for that amount at risk and make judgments as to whether the costs are serving trust objectives or hampering the ability of the trust to accomplish its intended purpose. The fiduciary then must take appropriate action. Only life insurance policies using the universal policy design provide the transparency and flexibility to do this and only no-commission, no-surrender charge investment-related policies provide the trustee with sufficient liquidity to address the changing needs of the trust.

A fiduciary without the ability to make changes or adjustments that need to be made, as a result of having to manage fixed-premium, fixed-face amount contracts, is without the power to morph a life insurance contract to the purposes of the trust over the long duration of the typical trust. It comes down to the fact that the fiduciary of that life insurance trust has abdicated responsibility at policy inception and must just hope for the best in those fixed-premium, fixed-face amount life insurance contracts. The other option is to accept responsibility for a transparently designed universal contract and to exercise those powers responsibly.

4. Variable Life Involves Greater Risk Than General Account Only Life Insurance

Current credit shelter trust investments are in a carefully diversified and monitored portfolio of approximately 65 percent equity, 35 percent bond/interest investments, with an overall objective of long-term growth, with an estimated time period of twenty-five plus years, due to the good health of the surviving spouse beneficiary and family longevity.

There are no special circumstances of this trust or the trust beneficiaries that require the trustee to ignore the trustee's duty to diversify.

Could the trustee of a trust such as this rationalize investing the capital of this trust into the blind pool, essentially bond fund general account of a life insurance company based upon the terms of the trust and the UPIA of the regulating state? Or, would a policy design providing multiple investment accounts and multiple credible investment management firms, provided at acceptable transparent costs, be more likely to accomplish the trust objectives?

5. Life Insurance Company Illustrations, Both Initial and In-Force, Provide Credible, Action-Enabling Information

The typical, legally required life insurance policy illustration consists of many pages of projections based upon hypothetical charges and credits which are subject to change. What the policy owner chooses to invest may change, state premium taxes may change, M&E risk charge and monthly deductions for expenses and the cost of life insurance all are subject to change within contract limits. The illustration assumes that all of these are static and then applies some hypothetical linear rate of return from zero to 12 percent which is assumed to be earned on the net, after-expense policy capital. It can be said, with a high degree of accuracy, that the values shown in any illustration projections is what will ***not*** happen.

The one page provided by the fiduciary-friendly illustration system, that is used to determine the feasibility of the life insurance strategy, is the one that shows the deductions from the amount the trustee is considering investing into the contract, and the amount and cost of the amount at risk element provided by the life insurance company. This page might look something like this:

Age	Premium Paid	State Premium Tax	Cost of Insurance	Total Death Benefit	Approx Amt at Risk	Cost as a % of Investment
73	$200,000	$1,000	$17,701	$2,300,000	$2,100,000	9.35%
74	$200,000	$1,000	$16,020	$2,300,000	$1,900,000	4.26%
75	$200,000	$1,000	$14,214	$2,300,000	$1,700,000	2.54%
76	$200,000	$1,000	$12,270	$2,300,000	$1,500,000	1.66%
77	$200,000	$1,000	$10,184	$2,300,000	$1,300,000	1.12%
78	$0	$0	$9,678	$2,300,000	?	?
79	$0	$0	Actual	$2,300,000	Actual	% Capital

The fiduciary will need to document with the CPA the approximate competing cost of the current investment strategy and the income tax cost of managing the trust capital in the trust, which currently does not make distributions to beneficiaries and does not intend to in the foreseeable future.

The extent to which the life insurance strategy exceeds the cost of the current strategy in the early years can be considered the cost of the risk management features of the life insurance which assures a minimum legacy regardless of market conditions. It also is the cost of picking up the step-up in cost basis on this capital at the death of the surviving spouse.

Once the strategy is adopted, the life insurance fiduciary will monitor and manage the policy knowing exactly what is going on in so far as actual costs of investment and the life insurance *amount at risk*. For example, knowing the current cost of *amount at risk*, the life insurance fiduciary may choose to reallocate the investment capital. The capital allocated to the fixed-rate general account of the life insurance company could be increased so that the 5 percent, that the account currently may be earning, could generate sufficient earnings to cover comfortably the monthly deductions for the cost of life insurance. The other investment accounts would not be disturbed to pay those costs. It would be easy for all to see that the income tax free earnings on the amount allocated to the general account would be paying for the life insurance and that the death benefit is being guaranteed by this policy owner strategy. As a result of the transparency of this type of policy and the continually updated information on the cost of the life insurance, the fiduciary for the policy controls the guarantee of the death benefit by making sure policy resources are available to pay the policy costs. During a general market swoon, such as 2000, 2001, and 2002, the costs of insurance would increase each month that the capital in the policy went down (as a result of the commensurate increasing amount at risk). This increasing amount at risk would offset the market decline and would maintain the $2,300,000 legacy. The life insurance fiduciary will no longer be constrained by income tax consideration or expenses in the ongoing management of the policy capital deployed among the investment offerings of the policy to best accomplish trust purposes.

Conclusion

As a result of the process followed by this life insurance fiduciary trustee, it was possible for the trustee to determine and to document the positive answers to these critical questions.

1. Can a life insurance strategy match the current trusts investment opportunities and diversification with credible, transparent and competitive costs?

2. Can the life insurance strategy mitigate the current income tax expense of the trust?

3. Can the life insurance strategy provide a step-up in cost-basis at the surviving spouse's eventual death?

4. Exactly what is the cost of the risk management feature of life insurance *amount at risk* that assures a legacy even if the surviving spouse should die during a bear market?

5. Can this trustee assure the continuation of the life insurance death benefit by making sure that resources are available to meet the monthly costs of life insurance?

For the trustee that can answer these questions affirmatively and who has the agreement and concurrence of all of the beneficiaries of the life insurance strategy, such a strategy may well reduce risk and increase the likelihood that a trust can accomplish its objectives. This type of policy (a no-commission, no-surrender charge fiduciary friendly variable universal life insurance policy design) provides a trust investment that can be easily monitored and managed.

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[1] Uniform Prudent Investor Act, Drafted by the National Conference of Commissioners on Uniform State Laws and by it Approved and Recommended For Enactment in all the States at its Annual Conference Meeting in its One-Hundred-And-Third Year in Chicago, Illinois July 29 – August 5, 1994 with prefatory note and comments, Approved by the American Bar Association, Miami, Florida, February 14, 1995 and available in full at www.ifa.com/Media/Images/PDF%20files/UniformPrudentInvestorAct.pdf.