



*Unlocking Business Wealth*

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# Life Insurance in Estate Planning

*By Joel Kabaker*

## How to Monitor Trust-Owned Life Insurance

“I’m no insurance expert,” claimed Sam Macinaw. “I am an estate planner who found these life insurance trusts lumped into the assets of two new clients. When I brought it to their attention, they decided to name me as the trustee. This occurred about twelve years ago. The policies looked okay to me. I wrote the Crummey letters when I was supposed to in order to qualify the annual premiums as a current gift to the beneficiaries. How was I to know the policies changed?”

The law says Sam should have known—or at least he should have been monitoring the policy performance and taken action when needed. Now the policies’ cash values no longer support the intended death benefit. Substantial premium payment additions must be made. Sam’s clients will likely sue him and win.

### **Insurance Trusts Require Hands-on Monitoring**

Creating irrevocable life insurance trusts (ILITs) is a popular estate planning technique to keep policy benefits—when paid—out of the insured’s taxable estate. Equally as popular is naming a trusted advisor as the trustee. This responsibility often falls on the estate planner, family attorney or trusted accountant. If you are a trustee of an insurance trust, take heed. Your responsibilities are significant and more complex than those of a regular trust without insurance.

The Uniform Prudent Investor Act (UPIA) requires trustees to act in a fiduciary capacity. As such, the trust charges them with carrying out the trust’s objectives for its beneficiaries. The operative word for a life insurance trust is beneficiaries, not the insured. Even though the insured may have established the trust, purchased the policies and appointed the trustee, the trustee must act as a fiduciary for the beneficiaries alone.



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Being the trustee of a life insurance trust is challenging. First, the trustee has to follow the rules of a trust document he or she did not write. Trustees have to manage life insurance policies that others selected. Reasons for choosing a particular structure may not always be clear. The trustee must come up with the funds to make premium payments when the trust may not have received them yet. Finally, the trustee cannot revise the terms of an irrevocable trust to deal with the unexpected.

## What Can Go Wrong?

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The UPIA requires that trustees maintain active involvement in the management of the trust. The beneficiaries can hold trustees personally liable for losses if they perform in a substandard manner or give preferential treatment to one beneficiary over another. A number of things can go wrong in an insurance trust. Watch for these in particular:

- **Performance gap:** A gap emerges and widens over time between the trust's intent and the insurance policy's performance. To discover this trend before it is too late, review the trust assets within a reasonable time after accepting trusteeship or receiving trust assets. Then conduct a regular, comprehensive policy performance review. Hire an expert insurance professional if necessary to assist.
- **The curse of longevity:** People today live longer. Policies purchased years ago may not last the lifetime of the beneficiary. Restructure if necessary to make the insurance trust benefits consistent with the trust's intent.
- **Non-standard premiums:** Flexible premium payments can doom policy performance. The scheduled premium shortfall is supposed to be made up either from investment portfolio performance or more likely, additional premiums contributed to make up for previously skipped premium payments. However, the carrier's investment income could be too low, operating expenses too high or mortality charges greater than originally projected. Either way, the premiums come up short. This reduces cash value, causing the benefits to weaken or possibly fail to be paid entirely.
- **The carrier's financial stability changes:** A prudent trustee conducts regular reviews of the insurance carrier to satisfy themselves that the carrier can perform as the trust intends. To begin this process, determine if any of the rating services have downgraded the carrier and if so, why. Change carriers

if necessary and if possible. Changes in medical history may make the cost prohibitive or even impossible to acquire new insurance. Document the analysis, conclusions and actions taken.

- **Analyze the policy performance:** Request and analyze an in-force illustration of the policies contained in the trust once a year. Make necessary changes to maintain performance as intended in the trust documents. Document analysis of the in-force illustrations, conclusions and any changes made. Consult an insurance expert if necessary to interpret the in-force illustrations.

## Causes for Underperforming Policies

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There are many reasons for insurance policies underperforming their targets. One of the most common is the assumptions used in the premium payment patterns. The policy cash value must be at a level sufficient to support a specific death benefit. If premium payments fall below that level, then there is a problem.

A second common cause for underperformance comes when the policy's actual performance lags that which was originally illustrated and modeled. If policy performance is monitored regularly, a small correction may be all that is required. On the other hand, if many years have elapsed, the monetary shortfall could be enormous.

A third common problem occurs with the beneficiaries themselves. Often, their life circumstances change. Let us say they now require an increased death benefit to maintain their lifestyle once the insured passes. Assume also that the trust's stated intent was to provide those funds from policy proceeds. The trustee must now make adjustments in the policies or the trust assets to fulfill the trust's intent.

## Reconcile the Trust's Intent with Current Performance

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Study the trust's stated intent. Compare it with the policy's current performance. Here are five points of which you should be particularly aware:

1. **Intent:** Provide a specific death benefit of a stated dollar amount.  
*Reconciliation:* Determine if the current policy provides the required death benefit level. If not, then change policies if possible.
2. **Intent:** Provide required insurance at an established and stated cost.

*Reconciliation:* Compare premiums of the existing policies against those of new policies currently available on the market. Change policies and carriers if possible to bring costs into line.

3. *Intent:* The trust is established to maintain a particular lifestyle level.

*Reconciliation:* Determine that the beneficiaries have not developed unexpected situations that would require substantially more money to maintain the intended lifestyle. Examples include multiple marriages with child support payments for two or more families or a child with an unanticipated medical problem.

4. *Intent:* The trust provides benefits for stated relatives and family members.

*Reconciliation:* The insured unexpectedly dies without changing the beneficiary of the trust and/or the insurance policy to their new spouse and family. Now the trustee faces a discrepancy between the trust's stated intent and the revised intent of the insured and trust maker. Remember that the trustee owes a fiduciary duty to the trust's beneficiaries rather than the trust maker or insured. Our advice to a trustee given such a case is to engage qualified counsel as soon as possible.

5. *Intent:* The policy is meant to remain in force throughout the insured's life.

*Reconciliation:* Due to cash withdrawals and loans against cash values, or underperformance by the insurance company the policy has lapsed during the insured's life time. The trustee must take action to either reinstate the policy or acquire a new policy that accomplishes the stated intent if possible.

it. This Statement identifies how you will manage the insurance trust's assets. Just some of the things it should cover include the following:

- The trust's purpose
- Time frame
- Trust contributions—amounts and timing
- Distribution provisions
- Beneficiaries and updated contact information
- Policy management directives including active and passive management
- Investment policy related to diversification of assets and undue concentration
- Liquidity
- Use of outside experts
- Policy review procedures and frequency

If you are a new trustee, immediately review the insurance policies in the trust and make all necessary changes. Hire an insurance expert (a real expert, not just a friend who happens to hold an ancient, unused insurance license) to assist if necessary. Use of an expert may reduce exposure to liability. Know the market for new insurance policies that accomplish the trust's intent. Determine the cost and benefits of new policies compared to the original in the trust. New policies often include:

- lower cost for the same coverage due to improved life expectancy;
- better underwriting standards;
- lower operating costs of the insurer, therefore improved performance; and
- New riders that better accomplish the trust's intent.

Many older policies include a scheduled step-up in premiums that make them more costly compared to similar new policies on the market. Attention to such detail—no matter how small—again points out the fiduciary's duty to the beneficiary rather than the insured. This always remains true even though it was the insured who appointed the trustee.

## **Action Items for Trustees**

There are several additional things trustees can do to ensure their compliance with the trust intent and to fulfill their responsibilities to the beneficiaries. First, be sure you clearly understand your duties as specified in the trust document. List them. Next, draft an Investment Policy Statement and be sure to follow

## **Checklist of Actions**

The author is happy to provide a checklist for trustees working with insurance trusts. Please contact me *via* phone or e-mail.

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