SAGE *Solutions*

R_x: The Life Insurance Review

By Robert W. Finnegan, J.D., CLU

Clients regularly review their investment portfolios. Clients rarely review their life insurance portfolio. Yet life insurance is an extremely complex and sophisticated product that is frequently misunderstood. For example, it is not unusual for clients to overestimate the nature of policy guarantees. After paying substantial premiums for years, the policy may be in danger of lapsing. Oftentimes the product is made more complex by the context within and need for which it is purchased. Although this article emphasizes trustee liability relative to life insurance in the estate planning context, ***every life insurance policy should be reviewed periodically to ensure that it is performing as expected and that it is positioned to optimally meet its intended need***.

As a general rule, life insurance death benefits are income tax free. However, life insurance that is personally owned by the insured is included in his or her taxable estate and subject to state and federal estate taxes that could be in excess of 50%. Ownership by the insured's spouse only defers estate inclusion until the second death.

The irrevocable life insurance trust or ILIT is a tried and trusted strategy designed to exclude the policy proceeds from the taxable estate. A properly structured and funded ILIT provides an income, gift and estate tax free source of cash upon the death and can be used to pay estate taxes. Frequently, along with the core documents (will, revocable trust, health care proxy, living will and power-of-appointment), life insurance in an ILIT forms the backbone of the estate plan.

One of the most challenging issues facing the grantor of the ILIT is selecting the trustee or trustees. The trust is irrevocable, so it cannot be changed, and will continue for many years into the future. Frequently, one or more family members, friends or professional advisors are enlisted to serve as trustees. Most individual trustees don't realize that the role of trustee carries significant responsibilities.

Primary among these is the fiduciary duty to manage the assets of the trust for the benefit of all of the trust beneficiaries. Many times this means balancing competing interests, for example, a spouse may be entitled to income for life, with balance at her death equally to children. If the trustee pays out too much in income, there may be substantially less available for the children. If no income is paid out, there is more for the children at the expense of the spouse.

In our increasing litigious society, no one is exempt from lawsuits, not even family members. The trustees of a life insurance trust have a fiduciary duty to manage the policy in the best interests of the beneficiaries and to ensure that the policy is performing as intended.

It is therefore essential for trustees to regularly review the life insurance policies owned by the trust. Minimally, this means every three years or sooner if there is a major change in

Sage Hill Advisory & Management
18 Division Street
Suite 210A
Saratoga Springs, NY 12866
Main: 518-871-1214
www.sagehilladvisory.com

SAGE HILL
Advisory & Management

the insured's family or if there are major tax law changes. An insurance review addresses two major questions. First, is the need for life insurance still valid? Second is the insurance policy correctly positioned and performing to best meet that need?

<u>1. Is There Still a Valid Need for Life Insurance?</u>

Regarding the validity of the life insurance need, the estate may no longer be subject to estate taxes or it may be subject to reduced taxes. This may have been due to depreciation of assets or a rise in the amount the government allows to pass estate tax free (the estate tax laws are in a state of flux right now). Even if the insurance is no longer needed for estate taxes, it may be needed for estate creation. In other words, it may replace the value of assets beat down in the present economy.

If the insurance is not needed for estate taxes or estate creation, as a purely economic decision it may still make sense to continue the coverage in force. Regarding any decision to reduce or eliminate coverage, the insured's health should be evaluated objectively. If the insured's health has declined and the insurance was issued at preferred or standard rates, it may make sense to keep paying premiums. As an alternative, there may be sufficient cash values to carry the coverage with no further premium payments.

If it is determined that the insurance will not be kept in force, it may make sense to surrender the policy for its cash surrender value. For individuals age 70 or older and depending upon health, it may make sense to sell the policy rather than cash it in for the policy cash surrender value. The sale of the policy on the secondary market to institutional investors, called a life settlement, may generate substantial cash in excess of the policy cash values.

For example, in one case insuring an 82 year old woman, an existing $9 million policy was sold to third party institutional investors. The family received $1.1 million more than if they had merely surrendered the policy. They was able to replace the coverage with fully guaranteed coverage, repay the loan on a complicated premium financing plan, and release over $500,000 of marketable securities collateralizing the loan.

Many clients unknowingly terminate term insurance when it is no longer needed when it might be possible to settle the policy for substantial value. A 69 year old client sold a $1 million term policy and received over $80,000 of cash. The client would have received nothing had he simply terminated the term policy. The same client sold a $1.25 million permanent universal life policy for $218,000, $150,000 more than the policy cash surrender value.

Any decision whether to change, continue or terminate coverage should be carefully documented to protect the trustee in the event of a future lawsuit. Hindsight is 20/20.

Sage Hill Advisory & Management
18 Division Street
Suite 210A
Saratoga Springs, NY 12866
Main: 518-871-1214
www.sagehilladvisory.com

SAGE HILL
Advisory & Management