

Life Insurance in Estate Planning

By Joel Kabaker, Jerry Simon and Mike Altman

The Three Worst Pitfalls of Life Insurance Trusts

On the surface, irrevocable life insurance trusts appear deceptively simple. After all, the trustee just has to pay the policy premiums when they come due while the insured is alive. When the insured dies, the trustee collects the policy proceeds and then disburses them to the trust beneficiaries, right? Wrong—well, sometimes wrong. Those instances when it is sometimes wrong can hurt your clients and create potential liability for you. Whether you draft irrevocable life insurance trusts as part of your estate planning practice or you serve as trustee for your clients, here are three pitfalls you should watch out for.



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Convertible Term Insurance

By definition, convertible term insurance allows conversion from a policy having a finite end to one that is a permanent form of insurance such as whole life or universal life. Conversion can take place at any time after policy purchase, but before the end of the contractual conversion period. Since each convertible term policy probably has a different conversion period, it is crucial the trustee be aware of exactly when the conversion privilege expires.

For example, let us say 50-year-old Tom's irrevocable life insurance trust owns a convertible term policy on him. Through a sad turn of events, Tom becomes uninsurable. The term of the policy is for 20 years and the conversion privilege runs for the first 10 years of the policy term only. During Year 11 (one year *after* the conversion privilege expired), Tom raises the issue of life insurance with his estate planner. "You are covered," explains the estate planner and trustee. "We will convert to whole life sometime during the conversion

period.” Two problems come to mind the trustee should have known:

1. Since the conversion period has already expired, there is no way to fix the problem of outliving the policy by moving it to a permanent form of coverage.
2. Tom will only be 70 when the term policy expires. Statistically, he is likely to outlive the policy. The estate plan had included proceeds from Tom’s life insurance policy as an integral part of its funding. Now, there will likely be a funding shortfall.

Tom’s estate now has a problem. The trustee could have bought a policy that was convertible for the entire term. Or he could have bought a permanent policy to begin with and not had to worry about conversion time.

The trustee will also likely face an issue related to the value of a foregone life settlement sale. Life insurance policies can be valuable, especially if the insured has health issues, like Tom, and is nearing the end of his life. If Tom is not insurable and the trustee allowed the conversion period of his convertible term policy to expire, then there is nothing to sell into the life settlement market,

nor does he have the ability to acquire a new life insurance policy. A life insurance policy under this set of facts would have likely been valued at several hundred thousand dollars had the trust been able to sell the policy. Table 1 shows the order of magnitude for the value of such a policy.

Though the proceeds would have been at a discount to the value of the death benefits paid when Tom dies, at least there would have been some value

received, possibly in the seven figures. Now there is none.

The trustee’s liability derives from the fact he is the fiduciary of the trust and charged to act for the benefit of the trust’s beneficiaries.

Of course, this includes managing the conversion privileges of any convertible term policies. From the above example, the trustee has two potential liabilities:

- The \$10 million dollar death benefit that cannot be collected since the trustee allowed the term policy conversion period to expire on an individual who is no longer insurable
- The potential value of the converted policy if sold in the life settlement market

The estate plan is in a disadvantaged position because of this error.

What happens, absent language defining possible future sale of the policy, if there is a divorce and remarriage?

Table 1. Estimated Life Settlement Value of a \$10MM Benefit Policy

Male, age 70, \$341,576 in annual premiums	Low estimate	Medium estimate	High estimate
Active, healthy	\$ 523,420	\$ 681,391	\$ 1,047,654
Standard health	\$ 1,232,594	\$ 1,455,526	\$ 1,907,682
Slightly impaired	\$ 2,230,881	\$ 2,503,635	\$ 3,010,467
Impaired	\$ 3,130,832	\$ 3,422,110	\$ 3,938,080

Male, age 74, \$439,587 in annual premiums	Low estimate	Medium estimate	High estimate
Active, healthy	\$ 768,975	\$ 941,365	\$ 1,334,474
Standard health	\$ 1,446,606	\$ 1,666,107	\$ 2,114,572
Slightly impaired	\$ 2,302,365	\$ 2,558,439	\$ 3,041,969
Impaired	\$ 3,388,336	\$ 3,663,512	\$ 4,151,845

Source: CPS Advantage

Trust Documentation Describing Future Insurance Policy Sales

Life insurance policies grow in value over the years as the cash surrender value builds. Value also grows according to life circumstances of the insured. As we saw in Table 1, the older an insured is and the more questionable his health and expected longevity, the more the life settlement market values the policy.

What happens, absent language defining possible future sale of the policy, if there is a divorce and remarriage? The trustee probably needs to sell the policy from the original trust whose beneficiaries are the (now) ex-

wife and children. The buyer is a new trust whose beneficiaries likely include the new wife, her children, their children and the insured's children from prior marriage(s).

But what is the price the new trust must pay? Is it the cash surrender value? The trust selling the policy would likely claim that amount is low. Could it be the sum of all premiums paid over the life of the policy from inception to date? At least that solution makes the original beneficiaries whole in terms of out-of-pocket expense, but ignores any appreciation of the policy due to the insured's change in life expectancy. Or, if the insured is old enough, is it the going rate paid by the life settlement market? The trust buying the policy would probably say that amount is too high.

And finally, for whom is the trustee working? The beneficiaries of the first trust? The (now) ex-wife? The kids? Whose kids? What happens if the insured names the same trustee to administer the new trust whose beneficiaries include the new wife and new family? This apparent conflict would place the trustee in the position of negotiating the buy and sell price of the policy with himself.

The best solution is to preemptively incorporate language into the irrevocable life insurance trust that defines a number of actions the trustee may take given identified circumstances. We advise including at least these topical sections that deal with possible sale of the insurance policies contained in an irrevocable life insurance trust:

1. Include language regarding orderly disposition of the policy in the event of a divorce and possible sale of the policy
2. Grant the trustee the right to make specific decisions regarding possible future sale and purchase of the policy
3. Reaffirm the trustee's duty to act in the best interests of beneficiaries
4. Describe the various options of valuing the policy. However, be aware that any formula incorporated into the trust will have so many variables and caveats it will be all but useless over time. Also, if the document identifies the life settlement market as a possible indicator of policy value, the insured must be of an age and health status that will provide a valid quote. If he or she is too young, there will be no market and no quote.

The policy valuation language may refer to the table of cash value contained in the policy itself.

However, be aware these values are based on the insurance company's former role as that of being a "monopsony" (a market where only one large buyer exists). As such, these prices are generally far below those of the life settlement market and often even less than the total of the premiums paid.

Split Dollar Considerations After the First Death Using a Second-to-Die Policy

Split dollar is not an insurance policy. Rather, it is a *plan* to pay for life insurance. A split dollar plan shares insurance premium payments, death benefits and cash surrender values between two parties. Often the parties are an employer and a selected employee. As the headline foretells, the complicating factor for many split dollar policies is the second-to-die provision. When the first person dies, the cost of maintaining the policy dramatically increases. The reason is that the probability of getting a death benefit from one person insured is far greater than that of two people insured. An example is:

- two-person split dollar plan for purchase of life insurance with a \$10 million death benefit at age 75 has an economic benefit cost of \$10,920, and
- once the first person dies the (now) single person split dollar plan for the same life insurance has an economic benefit cost of \$330,500

The new imputed cost of the employer's contribution comes from IRS valuation tables. Imagine the tax impact of receiving that increase in cost.

The point here is the trustee must be aware of and anticipate the cost escalation when the first person dies. The trustee may also have a plan to change from the split dollar arrangement to another way of paying for the premiums. The risk of ignoring this probable event is to incur a crippling payment and gift cost.

The trustee must decide to allow the policy to lapse or continue paying the premiums. If the trustee elects to continue paying the premiums, from where will the funds come? The trust may have sufficient cash to pay the premiums. Alternatively, the trust could borrow the needed funds. Purchase of a term life insurance policy on both insureds equal to anticipated premium payments would make the trust whole on the death of the

first insured.

The overriding point of this column is that trustees of irrevocable life insurance trusts need to pay

attention to a variety of variables and act on them when necessary. This is no time to put the trust on autopilot and hope for the best.

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