WELLSPRING ASSOCIATES
A HIGHTOWER COMPANY

WHITE PAPER

Life Insurance Audits vs. Life Insurance Reviews

WHAT YOU DON'T KNOW CAN HURT YOU—FIDUCIARY LIABILITY IS REAL

We live in a litigious world. We can ignore this fact, but it doesn't make it less true.

What you don't know can hurt you and pleading ignorance as a defense is not a good strategy.

If you are the trustee of a trust that owns life insurance, you should know the difference between a *life insurance audit* and a *life insurance review.*

Before we define the difference, consider being the trustee in the following conversation. How would it make you feel?

> *"Hey honey, I know you've had a long day, but it seems like something is bothering you. What's wrong?"*
>
> *"Well, I had a conversation today at work that makes me a little worried that I might get sued!"*
>
> *"What in the world are you talking about?"*
>
> *"Jack's daughter came in to talk to me today and she was pretty upset. I hadn't seen her since Jack's funeral. Apparently since Jack died, she has been meeting with an advisor to help her with estate planning."*
>
> *"Her advisor told her that the life insurance policies on Jack that were owned in his insurance trust, where I was the trustee, were old policies that had high enough cash values that they could have been exchanged for policies with much higher death benefits."*
>
> *"If that's true, wouldn't you have known that? I thought you were meeting every year with the agent who sold those policies?"*
>
> *"I was, and he always reviewed how the policies were performing. They always seemed to be performing well and I thought they were in good shape."*

"According to Jack's daughter, her advisor told her that the cash values were so high in one of the old $20,000,000 policies that it potentially could have been exchanged for a newer $40,000,000 policy with no additional premium."

"She is pretty upset that I never considered that possibility. I have a fiduciary responsibility to look out for the best interests of the beneficiaries of the trust."

"Wow! I can't believe the agent never brought that up."

"I know, but that is not the only problem. The advisor also told her that the insurance trust will distribute all the assets to her outright when she reaches age 40, so it will all be in her taxable estate when she dies. That means that 40% of the assets could be paid to the government as estate taxes instead of passing down to Jack's grandchildren. That could be an $8,000,000 mistake!"

"The advisor said that Jack could have drafted a new insurance trust that would have held the assets in trust for multiple generations with no estate taxes. Apparently, there are ways that Jack could have then transferred the life insurance from the old trust into the new trust."

"How could you have possibly known that? Jack knew that you're not an estate tax expert when he asked you to be the trustee of his life insurance trust."

"That's true, and I was only serving as trustee as a favor to Jack. I was always so busy helping him run the business as the CFO that I never would have had time to research that kind of stuff. I thought all I had to do was make sure the premiums got paid every year and make sure the policies stayed in good shape."

"Jack's daughter, though, says I could have some serious liability for not ever looking into those alternatives that could have benefited the trust beneficiaries. She says I have potentially cost her family $28,000,000!"

"If only I had been made aware of those issues, I could have done something."

How would being the trustee in that conversation make you feel?

Avoiding this situation could start with understanding the difference between a *life insurance audit* and a *life insurance review.*

IDENTIFYING PROBLEMS WE DON'T KNOW EXIST

Some of the most significant problems we face in life are often the problems we don't know exist.

If a person has cancer and doesn't know it, we can all recognize that they have a significant problem. We also know that if someone is unaware of a problem, they generally are not working to fix it and that is what makes undiagnosed problems so insidious.

One of the best methods to uncover problems that you don't know exist is to go through an independent audit process. This method works for discovering accounting issues, medical issues and, yes, even issues with life insurance coverage.

Many trust-owned life insurance portfolios have significant problems unknown to the trustee. A life insurance audit can uncover these problems so that the trustee can address them before they grow too large.

In this article we will define what a life insurance audit is, explain how it differs from a life insurance review, and explore the following:

> WHO CAN BENEFIT FROM A LIFE INSURANCE AUDIT
> HOW OFTEN AN AUDIT SHOULD BE PERFORMED
> ISSUES THAT SHOULD BE CONSIDERED IN AN AUDIT
> BENEFITS OF GOING THROUGH THE PROCESS
> LIABILITIES OF NEGLECTING THE PROCESS
> EXECUTIVE SUMMARY OF A CASE STUDY

DEFINITIONS

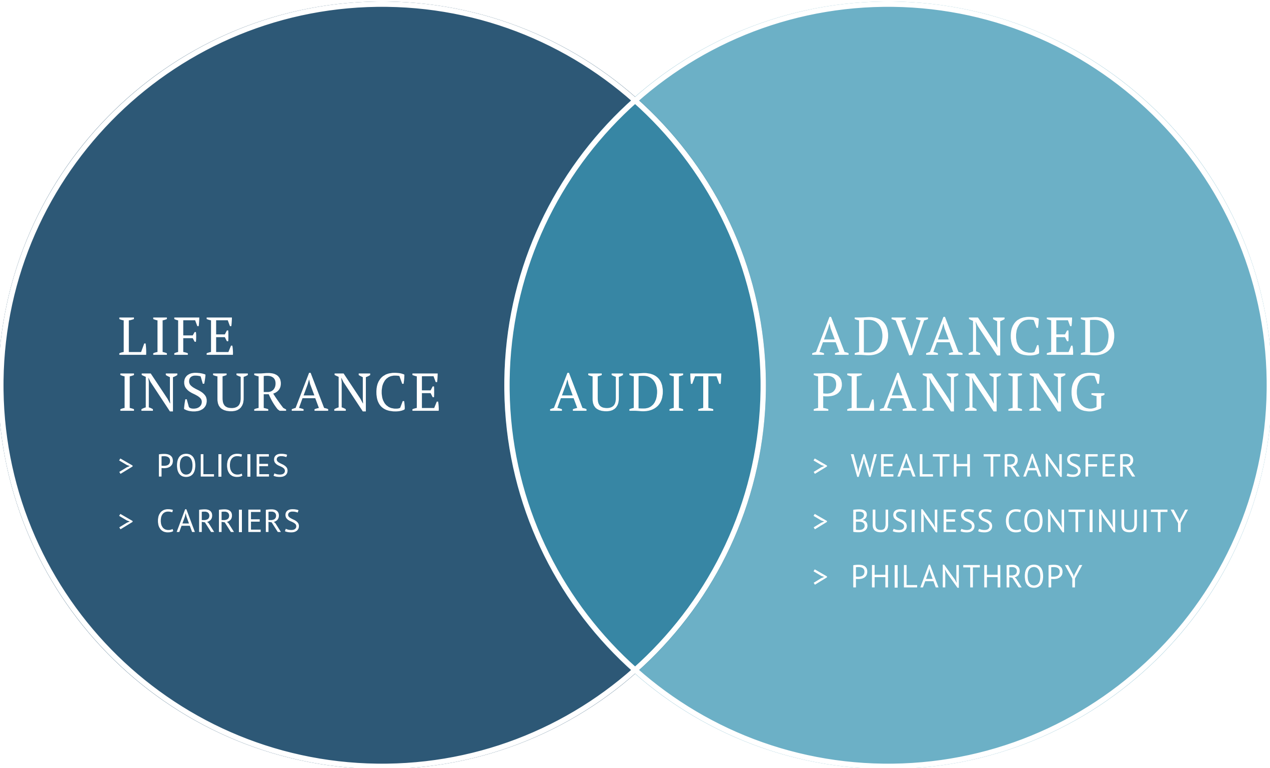
Life Insurance Review

> TYPICALLY PERFORMED BY THE AGENT WHO PLACED THE COVERAGE
> FOCUSED ON THE LIFE INSURANCE POLICY ITSELF
> USUALLY PERFORMED FREE OF CHARGE
> TYPICALLY DONE ANNUALLY OR LESS FREQUENTLY

DEFINITIONS *continued*

Life Insurance Audit

- PERFORMED BY AN ADVISOR WITH EXPERIENCE IN BOTH ADVANCED FINANCIAL PLANNING STRATEGIES *AND* LIFE INSURANCE CONTRACTS
- FOCUSED ON THE POLICY AND HOW IT FITS INTO THE OVERALL PLANNING
- PERFORMED BY A LICENSED, FEE-BASED LIFE INSURANCE COUNSELOR
- TYPICALLY DONE EVERY THREE TO FIVE YEARS



A life insurance audit consists of much more than just reviewing the performance of the life insurance policy and the strength of the carrier. It examines how the policy fits into the overall planning and all the aspects that surround that level of advanced planning. Therefore, the person who performs the life insurance audit needs to have experience in both life insurance and advanced planning. Life insurance knowledge alone is not enough.

WHO CAN BENEFIT FROM A LIFE INSURANCE AUDIT?

> ANYONE WHO HAS A NEED FOR **BOTH** ADVANCED PLANNING AND LIFE INSURANCE

> ANYONE WHO WANTS TO **MITIGATE OR ELIMINATE FIDUCIARY LIABILITY** AROUND LIFE INSURANCE OWNERSHIP

Fiduciary liability is real. It is important to keep in mind that what helps mitigate the liability is not what issues are uncovered, but the *frequency and depth of the audit.*

HOW OFTEN SHOULD AN AUDIT BE PERFORMED?

A rule of thumb is every three to five years.

An audit should also be completed after an event occurs that could affect the policy or the purpose of the coverage. Such events might include:

> MARRIAGE

> DIVORCE

> ADDITION OF NEW FAMILY MEMBERS

> TRANSFER OF A POLICY FROM ONE OWNER TO ANOTHER

> SALE OF A FAMILY-OWNED BUSINESS

> CHANGE IN NET WORTH

> TAX LAW CHANGES

> CREATION OF NEW TRUSTS

> CHANGES IN PRICING OF POLICIES FROM THE LIFE INSURANCE INDUSTRY

> CHANGES IN THE OVERALL PLANNING STRATEGY FOR THE FAMILY WITH RESPECT TO WEALTH TRANSFER, BUSINESS CONTINUITY, OR PHILANTHROPIC PLANNING

ISSUES THAT SHOULD BE CONSIDERED IN AN AUDIT

The depth of an audit matters. Think of it like the preflight check on an airplane. If the crew should review thirty items but only check five, have they performed their duties in a way that protects everyone on the flight?

The items that should be checked as part of a robust life insurance audit are numerous. As an example, the following list provides an idea of topics that should be considered, even though this list is not all-inclusive and not every issue will apply to every situation. Keep in mind that many items on the list involve how the life insurance may coordinate with advanced planning strategies because an audit is best suited for families that have a need for both advanced planning and life insurance.

- POLICY STRESS TESTS
- INTERNAL RATE OF RETURN ANALYSIS
- FUNDING CONSIDERATIONS
- TEFRA/DEFRA MANAGEMENT
- MODIFIED ENDOWMENT CONTRACT (MEC) ISSUES
- INCIDENTS OF OWNERSHIP
- UNDERWRITING EXPERTISE OF CARRIERS FOR SPECIFIC HEALTH ISSUES
- NAVIGATING REINSURANCE MARKET
- PRIVATE PLACEMENT VUL
- TERM CONVERSION LIMITATIONS AND RISKS
- PREMIUM FINANCING: 3RD PARTY AND PRIVATE
- LIFE SETTLEMENT FEASIBILITY ANALYSIS
- VALUATION OF LIFE INSURANCE POLICIES FOR SALES
- CRUMMEY LETTERS AND GST ALLOCATION
- TRANSFER FOR VALUE
- ASSET SWAPS
- GRAEGIN LOAN SUITABILITY AND PLANNING
- INTRA-FAMILY LOANS

ISSUES THAT SHOULD BE CONSIDERED IN AN AUDIT *continued*

> BUSINESS SUCCESSION LIQUIDITY POOL – FAMILY AND NON-FAMILY SHAREHOLDERS

> SPLIT-DOLLAR RESCUE

> COMPANY-OWNED LIFE INSURANCE (COLI)

> TRUST-OWNED POLICIES WITH LONG TERM CARE

> TAX STATUS OF TRUSTS: GST VS NON-GST TRUSTS/DYNASTY TRUST PROVISIONS

> 1035 TAX-FREE EXCHANGE MAXIMIZATION CONSIDERATIONS

> LIFE EXPECTANCY CONSIDERATIONS

> GIFT TAX ISSUES OF FUNDING TRUSTS

> MAKE UP PROVISIONS OF UNDERFUNDED POLICIES COMBINED WITH LIFE EXPECTANCY ANALYSIS

> SURRENDER CHARGE ANALYSIS WHEN REDUCING DEATH BENEFIT TO CONFORM TO POTENTIAL CHANGING NEEDS OF THE POLICY

POTENTIAL BENEFITS OF A LIFE INSURANCE AUDIT

> REDUCING THE FIDUCIARY LIABILITY OF THE TRUSTEE

> OBTAINING MORE DEATH BENEFIT FOR THE SAME PREMIUM

> PAYING LESS PREMIUM FOR THE SAME DEATH BENEFIT

> AVOIDING UNNECESSARY GIFT, ESTATE, OR GENERATION SKIPPING TAX (GST). AT CURRENT RATES OF 40%, THIS IS A SIGNIFICANT ISSUE SINCE THE SAVINGS IS ON THE DEATH BENEFIT FOR ESTATE AND GST TAX.

> SIMPLIFYING COMPLICATED FUNDING STRATEGIES LIKE SPLIT DOLLAR

POTENTIAL LIABILITIES OF NOT GOING THROUGH A LIFE INSURANCE AUDIT

Not addressing the fiduciary liability of the trustee is one of the main liabilities of not going through the proper audit process.

HYPOTHETICAL EXAMPLE OF WHAT A LIFE INSURANCE AUDIT COULD UNCOVER:

Facts

> High profile family in the northeastern united states with longstanding personal relationship with the life insurance professional

> $90,000,000 Life insurance portfolio on four lives

> All coverage owned in irrevocable trust

> $30,000,000 second to die: father *(age 72)* and mother *(age 68) owned in non-gst trust*

> $20,000,000 On daughter #1 *(age 50) owned in gst trust*

> $20,000,000 On daughter #2 *(age 40) owned in gst trust*

> Each daughter owned $10,000,000 term insurance *in non-gst trust*

> Split dollar used to pay premiums *(complexity)*

> Variable universal life had been replaced with guaranteed universal life for the parents, and survivorship had been replaced with individual after daughter's divorce.

> Five different carriers and four different product types *(good diversification)*

> Not looking for additional coverage or help with current life insurance portfolio. Family feels like everything is all "buttoned up." *(Typical)*

Summary of the Main Benefits from the Audit

1. Significant potential tax savings: **$27,200,000** with more savings possible
2. Simplification of the funding of the policies by eliminating the need for the current split dollar plan
3. Significant potential premium savings: potentially **$8,380,000** by life expectancy
4. Improved risk management and management of fiduciary responsibility

All the benefits of this audit were achieved without replacing a single policy.

BENEFIT 1A

$11,200,000 tax savings ($28,000,000 x 40% tax rate = $11,200,000)

OBSERVATION

$30,000,000 of Survivorship coverage owned in the children's taxable estates

SOLUTION

Sold policies from a non-GST trust to a GST trust for the ITR amount of $2,000,000 ($30M–$2M = $28M amount removed from taxable estate)

BENEFIT 1B

$16,000,000 tax savings ($40,000,000 x 40% tax rate = $16,000,000)

OBSERVATION

$40,000,000 of coverage owned in GST trusts, but no allocation of GST exemption had been made to the transfers

SOLUTION

Late allocations of GST exemption were made to the trusts based on the value of the policies

BENEFIT 1C

Preserve estate tax exemption which leads to future estate tax savings

OBSERVATION

$10,000,000 of term insurance on each daughter in non-GST trusts. No one was accounting for the annual gifts of the premiums to the trusts each year. This caused unnecessary use of lifetime exclusion, which could be better utilized in the overall estate plan.

SOLUTION

One daughter sold her policies to a GST trust, that had incomeproducing assets so that no more gifts were required, and other daughter took her coverage out of trust.

BENEFIT 2

Simplify funding of policies by eliminating the need for the current split dollar plan

OBSERVATION

All policies were in trust and being paid by a complicated split dollar funding arrangement. The complexity bothered the client.

SOLUTION

The life insurance plan was properly coordinated with the overall wealth transfer plan. Income producing assets were sold to the GST trusts so that there was sufficient income to pay all the future life insurance premiums, note payments from the sale of assets, and also pay back all the money owed from the legacy split dollar agreements.

BENEFIT 3

Significant premium savings to life expectancy identified

OBSERVATION

Identified potential funding problems with the parents' $30,000,000 second to die policy

> $30,000,000 funded with $100,0000 per year to guarantee the policy to age 90

> At age 91 the premium to guarantee to age 100 jumps to **$3,800,000** per year for ages 91 to 100

> **61%** statistical likelihood the policy will be in force at age 91 requiring more premium. Joint life expectancy age 93 which could result in two premium payments of $3,800,000 to get from age 91 to age 93

SOLUTION

Raise the current premium from $100,000 per year to $200,000 per year to age 100 to avoid the $3,800,000 annual premium starting at age 91. Paying more currently could save substantial premium later while still maintaining an impressive Internal Rate of Return (IRR) on the death benefit.

POTENTIAL PREMIUM SAVINGS		PROBABILITY OF DEATH	IRR
AGE 93	$ 8,380,000	50% PROBABILITY	13.0% (50% PROBABILITY)
AGE 97	$ 22,770,000	25% PROBABILITY	10.5% (75% PROBABILITY)
AGE 100	$ 33,500,000	7% PROBABILITY	9.1% (93% PROBABILITY)

BENEFIT 4

Mitigate fiduciary liability of the trustee

OBSERVATION

Trustees never had a life insurance audit of the portfolio.

SOLUTION

A detailed audit process was developed to help the trustees manage their fiduciary responsibility for the trust-owned life insurance portfolio.

> Risk is mitigated by the process and frequency of the audit, not the outcome

> Just by having an independent, objective, third-party audit, the trustees have taken a step toward risk mitigation

Key Take-Aways from the Audit (not all benefits relate to money)

> **BENEFITS 1A, 1B, AND 1C:** INVOLVED TAX SAVINGS

> **BENEFIT 2:** INVOLVED SIMPLIFICATION

> **BENEFIT 3:** INVOLVED PREMIUM SAVINGS

> **BENEFIT 4:** INVOLVED RISK MANAGEMENT

All the benefits of this audit were achieved without replacing a single policy.

A life insurance audit is an everything-to-gain, nothing-to-lose proposition for a trustee of a trust that owns life insurance where significant planning is in place. A proper, thorough audit is needed to mitigate the fiduciary liability.

We all will continue to have problems in our life that we are not aware of and, consequently, not working on to fix, but anyone who has trust-owned life insurance coverage and significant planning in place should be able to confidently reduce that list by one and hopefully eliminate the need for a stressful conversation similar to the one at the beginning of this paper!

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