One of the most common wealth transfer and estate planning techniques is to use an irrevocable life insurance trust (ILIT) to own life insurance policies. This structure enables individuals and families to direct the transfer of assets in a tax-efficient manner from one generation to another for the benefit of the trust's beneficiaries.

As with any trust, a trustee is designated to protect the interests of the beneficiaries and to manage the trust's assets for their benefit, while overseeing the administration of the trust itself. For ILIT trustees, these responsibilities may be more challenging than they sound, especially if the trustee does not possess the knowledge and experience to evaluate and manage the complex financial instrument that is a life insurance policy.

Some trustees of life insurance policies focus their efforts on handling gifts made to the trust, the proper and timely notification of Crummey beneficiaries, the payment of scheduled policy premiums and filing the trust’s tax return. However, under the standards set forth by the Uniform Prudent Investor Act, adopted in most states, a trustee holds the fiduciary responsibility to act with prudence and reasonable care in the management of trust assets at all times, concentrating on suitability, risk tolerance, diversification and tax consequences, among other things. For many ILIT trustees this role is reduced only to a cursory review of an annual policy statement.

There are many other factors involved in the prudent management of life insurance assets within an ILIT. To avoid potential liability exposures, it is advisable that ILIT trustees follow a clearly-defined, disciplined process for monitoring and evaluating life insurance policies, leveraging the resources of an experienced life insurance professional to assist with the process. When warranted, the trustee should initiate remedial action in accordance with the terms and provisions of the trust, the objectives of the grantor and the interests of the beneficiaries. The following is a brief discussion of some of the issues commonly involved in managing trust-owned life insurance policies. The checklist at the end of this paper offers a framework for trustees to follow when carrying out their duties.

(Continued)
POTENTIAL PROBLEM AREAS WITH LIFE INSURANCE IN AN ILIT

Policy Performance — Current Assumption versus Actual Experience

Life insurance used for estate planning purposes generally focuses on long-term or permanent insurance coverage. These policies balance tradeoffs among required premium levels, policy guarantees, and performance of the invested premiums. Most permanent policies are purchased and funded based on projections of several non-guaranteed assumptions, which influence all of the factors above.

It is incumbent on trustees to understand and examine the policy assumptions used by insurance carriers, including interest/earnings rates, dividends, and policy morality/expense charges. Variations in any of these will affect the long-term sustainability of the policy and future premiums required to maintain coverage, which could affect the ultimate amount of insurance. Regularly reviewing in-force projections of future policy performance will shed light on the reasonability and impact of the original assumptions. Trustees must be responsive to make necessary adjustments in premium patterns and how policy dividends and cash values are used.

Changes in Client Circumstances

Absent an ongoing process, which examines the grantor’s and beneficiaries' specific situations and the efficacy of the life insurance asset, a trustee can create exposure because the original insurance policy may no longer adequately serve the clients’ needs. The grantor’s estate liquidity needs may have changed to the point where more or less, life insurance is required. The trustee must evaluate whether the current policy should be liquidated or settled, to make better use of this asset in the trust or if additional coverage will be required.

The grantor’s objectives, with respect to the trust beneficiaries, also can evolve over time. If provisions within the trust are modified to provide different benefits to the beneficiaries, the trustee must ensure that these changes do not render the existing life policy insufficient or inappropriate.

Finally, if the trustee learns that the insured/grantor’s health profile has improved or if, for example, that the insured is no longer a tobacco user, then it is incumbent on the trustee to explore new alternative coverage options, which may result in lower costs or better guarantees toward achieving the trust’s objectives. An experienced insurance professional can assist the trustee by canvassing the market to assess the viability of newly underwritten coverage.

Evolution of New Policy Designs

The suitability of policies already in existence for some time should be reviewed not only in the context of changes in the original premise for the insurance purchase, but also in light of more current policy designs. Today’s product options include policies with fully guaranteed death benefits, more cost-effective premium schedules and lower insurance costs predicated on updated actuarial tables. When compared to older policies, a more currently designed policy may provide better value and do a more effective job of achieving the objectives of the trust.

To avoid potential liability exposures, it is advisable that ILIT trustees follow a clearly-defined, disciplined process for monitoring and evaluating life insurance policies.
Financial Strength of the Insurance Carrier

Trustees should pay attention to the financial condition and claims paying ability of the insurance carrier. This entails monitoring third-party ratings as well as gaining insight into company management changes, size and business diversity. For large insurance amounts, trustees should consider diversifying the insurance benefits among multiple carriers as a form of risk management.

All of these issues can be governed by a formal, documented Insurance Policy Management Statement (IPMS). Akin to an Investment Policy Statement used for other types of assets and investments, the IPMS will have set criteria and conditions, by which the trustee will monitor and manage the insurance policies in the trust. Ideally, these guidelines should have been established with the grantor in conjunction with the trust objectives before the insurance policy was entered into. However, an IPMS can be implemented at any time to provide a reliable road map for the trustee to meet objectives and to minimize personal liability.

Changes required as a result of a proper trustee review of life insurance may not necessitate replacement of the incumbent policy. Very often, trustees can remediate non-performing policy assets by restructuring premium flow, modifying the death benefit, eliminating unnecessary riders and other strategies. Such remedial actions will be required when the grantor’s insurability is no longer viable to consider newly underwritten coverage.

(Insurance Trust-owned Life Insurance — Monitoring and Due Diligence Checklist for Trustees on next page)
ILIT Trustees have a fiduciary duty to manage and monitor performance of life insurance assets in the trust for the benefit of its beneficiaries. To reduce the risk of personal liability and to maximize benefits for beneficiaries, trustees should develop and implement a defined process to manage policies. The following checklist is intended to help provide a framework for trustees.

- Examine the goals and objectives of the trust.
  What may have changed in the lives of the trust’s constituents? Are the needs of the beneficiaries the same as when the trust and/or life insurance policy was first established? Do the intentions and objectives of the grantor(s) remain the same?

- Establish a written Insurance Policy Management Statement defining the various criteria under which policies will be evaluated.
  This will address type of policy, amount of insurance, desired duration of premiums, quality thresholds for carriers, maximum amounts under any one carrier, tolerance for policy assumptions, use of dividends and other issues.

- Evaluate whether the amount of life insurance is adequate for the current and projected needs of the trust beneficiaries.
  If not, is additional coverage required? If more than enough, what options does the trustee have regarding the excess coverage and the value of the insurance asset in the trust?

- Obtain a snapshot of the policy and an in-force illustration.
  Compare projected future values with the original policy illustration assumptions and the most recent in-force ledger. This should be done at least every 2-3 years, with an annual review preferred. The trustee should examine premium funding requirements and projected values under varying assumptions, looking for trends in performance. If additional premiums will be required in the future, will there be sufficient gifting capacity for the grantor to avoid additional gift taxes?

- Assess changes in the health profile and/or habits of the insured person(s).
  Improvements in health condition, including the passage of time since diagnosis of certain medical conditions, may enable an insured person to obtain a more favorable underwriting classification on new coverage, resulting in lower costs to the trust. Also, reduction or elimination of personal habits (e.g., smoking cessation) can create similar opportunities.

- Periodically examine alternative types of life insurance policies available in the marketplace.
  Determine if there are more effective policy designs which can accomplish the objectives of the trust with greater certainty or at a lower cost.

- Review the ratings and financial stability of the insurance carrier(s) to determine if they have changed since the policy’s inception.
  Also check if this carrier remains viable to meet the long-term objectives of the insurance need for the trust. Are the policy amounts sufficiently diversified among multiple carriers?

- Document all actions taken during the review process.
  Establish the timing of the next scheduled review.

This checklist is an insurance-related summary prepared for your convenience. It is intended to neither replace or amend any particular insurance policy nor does it constitute as a contract, legal advice, or tax advice.