Folks:

Take-Away: Reviewing a life insurance policy held in an irrevocable life insurance trust (ILIT) is a complex, and often thankless, task for the trustee of that Trust.

Background: Each year a trustee of an irrevocable life insurance trust (ILIT) should review the performance of the policy or policies held in the Trust. Circumstances change, policies may drastically 'underperform,' and how the policy is financed may need to be revisited. Consider the following questions where a policy, or policies, held in an ILIT will need to be answered.

> **Policy Complexity:** Life insurance policies acquired by purchase, transfer, or exchange are getting more complex than their predecessor policies. These policies with their multiple provisions, 'riders', and options take a lot more time to fully understand. Does the trustee really understand the implications of all these complex policy provisions, options, policy riders, and how they work together to satisfy the ILIT's purpose?
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> **Decline in Interest Rates:** With the drop-in interest rates for almost a decade, many life insurance policies now 'underperform.' Does the trustee really appreciate how great that 'underperformance' is and the impact that the 'underperformance' has on when the amount of the death benefit, or if the death benefit will disappear when the insured attains age 100, e.g., age 86, or the promised dividends in the initial policy illustration that now lag?
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> **Exit Strategy Identified?:** What is the exit strategy for holding the existing life insurance policy if the settlor-insured is no longer willing to pay the premium, or he/she is unwilling to pay increased premiums if the premium increase is required to cover the increase in mortality costs that are required for the policy to perform to the underwriting's projected age of death, e.g., age 100?

Continuing Need for Life Insurance?: With the prior 'down' market and the increase in the applicable exemption amount, many insureds no longer believe that they even need any life insurance death benefit to provide the liquidity to pay federal estate taxes. What does the trustee do when the settlor-insured says he/she is unwilling to continue to make annual exclusion gifts to the ILIT to pay for unwanted (unneeded?) life insurance coverage?

Where is the Agent?: Many agents who helped to place the life insurance policies currently owned by the ILIT have 'left the playing field' due to a career change or retirement. Who helps the trustee communicate with the life insurance company to obtain current information on the insurance policy, its performance, and any potential financing arrangements currently in place to pay the annual premiums?

Current Policy Illustrations: How hard is it for the trustee to obtain current policy illustrations from the issuing life insurance company? How can the trustee compare the policy illustration that was initially issued when the policy was first purchased with the current policy illustration to confirm if the life insurance policy is actually 'underperforming?'

New Product Proposals: Insurance agents always seem to try to sell the 'newest and greatest' life insurance policy, e.g. universal life, which always seems to be 'better' than the whole life policy that same agent sold to the trustee just a few years back. Are those new policies better than the existing policy held in the ILIT? How can the trustee determine what policy is better suited to the purposes of the ILIT?

Policy Exchange, Surrender or Life Settlement? If it is determined by the trustee that the life insurance policy held in the ILIT is 'underperforming' the trustee has the choice of engaging in a policy exchange in the belief the new policy obtained for the old policy will perform better (maybe), or perhaps it can sell the policy using a life settlement arrangement, or simply surrender the policy for its cash surrender value. The tax implications of each of these options is different, so which does the trustee pursue if the decision is made to jettison an 'underperforming' policy?

Client Input: A review of the ILIT's policy by the trustee is not done in a vacuum, particularly when it comes to financing the policy if there is not a ‘side-fund’ of investments held in the ILIT that are available to pay the annual policy premium. The source of premium payments often goes back to the ILIT settlor. Exploring options to fund the existing ILIT policy may depend on what the trustee hears from the ILIT settlor. Possible feedback from the settlor might include some of the following comments:

> “I am concerned that that policy will not stay in force to the originally stated age, or perhaps a shortened period. I still want the insurance, so let increase the premium to sustain the policy to whatever age possible.” [Biting the bullet.]
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> “Unless, that is, that premium increase is so large that it makes sense to see if the policy is a candidate for replacement.” [Policy exchange.]
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> “I do not want to give up the coverage, but I really do not need this much insurance anymore.” [Negotiate a lower death benefit with the same policy.]
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> “I see that the premium will carry the policy to an age that my physician and I now know is far in excess of my life expectancy. I do not want to lose any of the coverage, but can we cut back the premium to carry the policy to a more realistic age?” [Exchange or renegotiate the death benefit with the same premium amount paid.]
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> “I don’t need it. I don’t want it. I won’t pay for it any longer. If you want to pay for it from investment income, or if the kids are willing to pick up the tab, that’s fine, but I am not paying anymore.” [Life settlement.]

Each of these responses or observations of the settlor-insured may lead to a different decision by the trustee regarding the existing ILIT policy. Keep in mind that with an ILIT, the trustee’s fiduciary duties are to the ILIT’s beneficiaries, and not to the settlor of the ILIT. And whatever decision the ILIT trustee finally makes, the trustee will inevitably be second-guessed by the ILIT beneficiaries. Hence, the continuing need to create and follow a procedure that documents the policy review and trustee’s decision-making process.

Conclusion: These are challenging times for those who hold life insurance policies, as most policies are ‘underperforming’ either due to the low interest rate environment of the past decade or because the placing agent ‘oversold’ the policy performance illustration when the policy was first placed. It is especially challenging for ILIT trustees who must make decisions to either maintain, exchange, sell, or surrender the existing policy, often without much critical information about the policy's performance, or the trustee lacks the requisite sophistication to fully understand the complex policy (and its riders and options) that it holds in the ILIT. Add to that challenge the precarious 'outside' source used to fund the policy held in the ILIT, and it is understandable that many ILIT trustees, who attempt to do their due diligence with regard to the policy, always feel as if they are 'under the gun.'

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