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The Prudent Investor and Trust Owned Life Insurance (TOLI)

PART 3

This article is the third and final installment of a three-part series that tackles the prudent investor rule and trust owned life insurance (TOLI). Parts 1 and 2 appeared in the January/February 2007 issue and March/April 2007 issue, respectively, of ABA Trust & Investments.

THREE DUTIES AND TWO OBJECTIVES FOR PROPER ILIT ADMINISTRATION

Under the Prudent Investor Act, irrevocable life insurance trust (ILIT) trustees must establish and follow a prudent process for determining the suitability of TOLI policy holdings and managing such TOLI holdings in response to changing market conditions. Compliance hinges on process, not performance.[1] Suitability of TOLI holdings is largely determined by two criteria: investment performance and policy expenses.

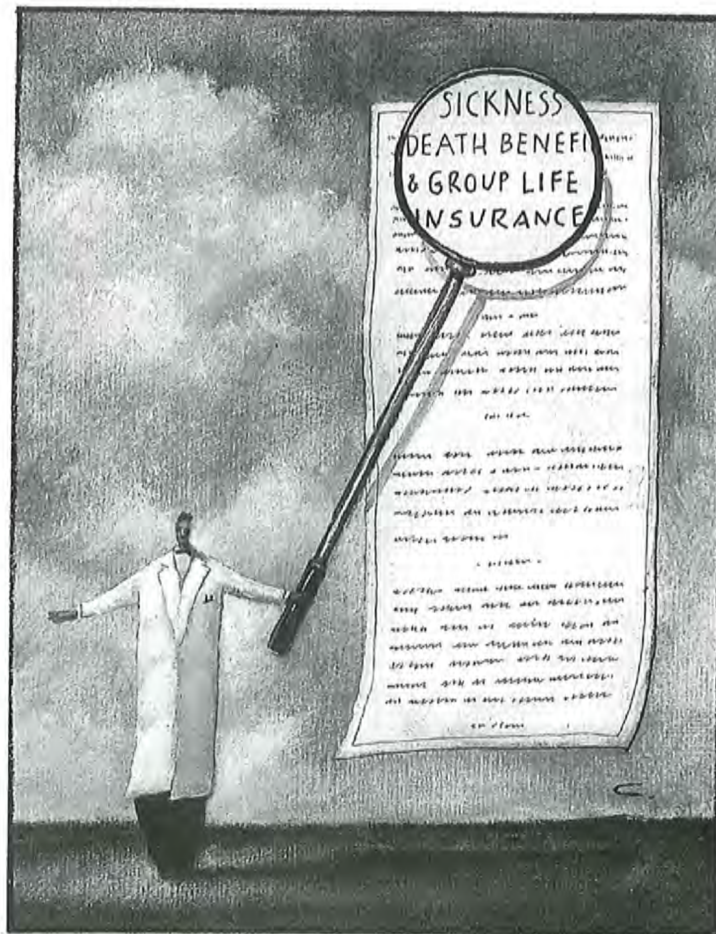
Christopher P. Cline and Barry D. Flagg

INVESTMENT PERFORMANCE

Investment performance for TOLI holdings is ultimately determined by the rate of return calculated on the life insurance proceeds received by the ILIT trustee upon death of the insured less the premium investment in the policy contract as measured over the holding period. For instance, the rate of return for a TOLI contract with a $1 million face amount and a $100,000 lump sum premium investment would be 23.25 percent if held for 10 years (i.e., the insured dies in the 10th policy year), 11.57 percent if held for 20 years (i.e., the insured dies in the 20th policy year), or 7.70 percent if held for 30 years (i.e., the insured dies in the 30th policy year).

Of course, these differences are due solely to the timing of the death of the insured, not the investment performance of the policy itself, and thus do not lend themselves to "a prudent process for investing" as required under the act. A better measure of investment performance for purposes required under the act is the investment performance of invested assets underlying policy cash values.

Measuring performance of invested assets underlying TOLI cash values is important for both compliance and practical reasons. From a compliance perspective, the act requires trustees to form realistic judgments about expected returns, and measuring investment performance is essential in determining whether such judgments are in fact realistic. In addition, because trust owned policies typically use investment performance to pay future and increasing cost of insurance charges in universal life and variable life policies, or to pay future premiums in whole life policies, as a practical matter the greater the expected rate of return on cash value investments, the greater the death benefit and the lower the risk of policy lapse.



Setting reasonable return expectations is even more important for TOLI holdings in ILITs than for other trusts holding other investments for a number of reasons. First, the magnitude of trustee liability related to the failure to set reasonable expectations as

to the performance of trust assets is considerable greater in ILITs than in other trusts. While trustee liability for other trusts is measured by the difference between actual performance and reasonably expected performance, liability for ILIT trustees can equal the entire TOLI death benefit.

Second, failure to set reasonable expectations as to the policy earnings rate can increase policy costs. Because COIs are calculated on the net amount at risk (NAR), and because the NAR increases when cash values fall short of original policy targets, failure to set reasonable expectations as to the policy earnings rate results in premiums that are insufficient to maintain target cash values, which in turn increases the NAR and therefore COI charges. In other words, failure to set reasonable expectations as to the TOLI earnings rate gives rise to trustee liability related to both deficient investment performance and excessive expenses.

Fortunately, there are a variety of investment research services available to ILIT trustees to help measure performance of invested assets underlying TOLI cash values, like Morningstar PrincipiaPro for the performance of separate accounts within variable life policies, and LifeLink VitalSigns for performance of insurance company general accounts underlying universal life and whole life policy cash values. Using such research to "paper the file" of an ILIT demonstrates the trustee is forming realistic judgments about expected returns as required by the act, mitigating lapse risk and the corresponding liability.

POLICY EXPENSES

Section 7 of the act states that "a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." In other words, trustees must avoid incurring costs that are not (a) justifiable and appropriate to the trust investment program or (b) reasonable in amount. Of course, the investment program for ILITs is generally comprised of TOLI policies that have both an investment element (i.e., invested assets underlying policy cash values) and an insurance element.

This means the ILIT trustee must justify both investment related expenses just like all other trustees as discussed above, and insurance related expenses specific to TOLI. For instance, while it is taken for granted that trustees measure fund management fees (FMEs) and other investment related expenses to justify as appropriate and reasonable in amount, ILIT trustees must also measure TOLI expenses as to cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based wrap fees (e.g., M&Es), and premium loads so as to also justify as appropriate and reasonable in amount.

For many years, the premium for TOLI policies was seen by the ILIT trustee as the "cost" due largely to underlying policy expenses not being disclosed and, in the absence of more complete information, the premium was seen as the "cost" of the policy by default. However, for most TOLI policies, the premium does not represent the cost of the policy, any more than a $2,000 contribution to an individual retirement account represents the cost of the IRA. The costs in either case are the expenses deducted from the premium paid or the contribution made.

As mentioned throughout, compliance with the Prudent Investor Act is determined by the trustee's conduct in establishing and following a prudent process, not by the trust portfolio's performance. The act also prescribes the ingredients for such a prudent process: (1) a duty to monitor performance of trust assets,[2] (2) a duty to investigate the appropriateness of trust holdings relative to peer group alternatives,[3] and (3) a duty to manage trust assets in a manner that demonstrably minimizes costs and maximizes benefits.[4] While this standard of care has governed investment and retirement trusts for decades, the application of this

standard of care to ILITs has given rise to a variety of new service providers to support ILIT trustees in the monitoring, investigation, and management of ILIT assets in the following three essential areas.

Step 1: Monitoring/Administration

Just as ERISA defines the standard of care for retirement trusts and creates the need for third-party administrators for administration and recordkeeping services, UPIA imposes administration and recordkeeping responsibilities on ILIT trustees, whose trust accounting systems often don't account for and administer premiums, cash values, and death benefits. As a result, several third-party administrators (such as Advicon, ILIT Analyzer, Resource Insurance Consultants, and TrustBuilder) have begun to provide such services.

Step 2: Investigation/Compliance

Investigating the suitability of a given ILIT policy requires obtaining the needed information about the particular policy and identifying its strengths and weaknesses. Therefore, in addition to seeking third-party assistance with TOLI administration, ILIT trustees are also seeking such advice with respect to a given policy's financial strength and claims-paying ability (i.e., default risk), cost competitiveness, pricing stability, cash value liquidity, and historical performance of invested assets. This assistance is being provided by individual agents, consultants, and independent life insurance product research providers like LifeLink Corp., Morningstar, and TheInsuranceAdvisor.com.

Regardless of how the investigation is conducted, however, ILIT trustees must dig deeper than reviewing illustrations when determining the reasonableness of investment performance and the appropriateness policy expenses. For instance, because illustrations show projected results based on combined investment and expense assumptions, they fail to provide trustees with the specific information about expected returns, COIs, FAEs, cash value-based wrap fees, and premium loads necessary to justify policy expenses. In addition, because illustrations are generally provided only to agents licensed with a limited number of insurers, comparing illustrations provides the ILIT trustee with only a fraction of the comparative data for the 100 insurers who underwrite 90 percent of policies each year, not to mention the thousands of products sold by the more than 500 insurers doing business in most states.

Step 3: Management

When the trustee has obtained the needed data and knows the strengths and weaknesses of a given policy, the trustee is able to manage trust assets in a manner that maximizes benefits and minimizes costs. Such management occurs when the ILIT trustee defines portfolio objectives, continually measures the policy's pricing and performance, identifies the policy's strengths and weaknesses, investigates available alternative products, and makes necessary changes to the portfolio stemming from this information.

Further, if the objective of the ILIT is to provide a defined death benefit (for instance, to finance an obligation like buy-sell agreement funding or estate tax liabilities), the trustee must also ensure that planned premiums and corresponding cash values are adequate to pay future and generally increasing policy expenses until the policy matures at the insured's death. The trustee can do so by periodically measuring actual policy cash values against cash value targets from the original illustration of hypothetical policy values. What follows are five activities for ILIT trustees faced with a policy that is overfunded (i.e., the cash values in the policy are more than the amount needed to properly fund the policy) or underfunded (i.e., the cash values in the policy are less than the amount needed to properly fund the policy):

- **Increase or decrease premiums.** When a TOLI policy is overfunded, trustees should consider reducing or refunding premiums to the extent projected cash values remain sufficient to cover existing future policy expenses (to the extent such expenses are justified). Conversely, when a policy is underfunded, the trustee should consider increasing planned premiums to increase cash values to cover future policy expenses (which may require the grantor to make additional gifts to the trust).
- **Increase or decrease expected death benefits.** Because benefits from overfunded policies can often be increased without additional gifts from the grantor, trustees should consider increasing overfunded policy death benefits (which may require grantor cooperation to do so). On the other hand, trustees should also consider reducing policy benefits in underfunded policies in order to reduce policy expenses to amounts supportable by existing cash values (to the extent such costs are justified).
- **Change cash value investment allocations.** If the ILIT holds a policy that allows investment allocations to be changed, the trustee should, at least annually, re evaluate the asset allocation appropriate to the trust objective and change TOLI cash value allocations accordingly.[5] For instance, in underfunded policies, trustees should consider a more aggressive asset allocation among asset classes with greater historical rates of return albeit with greater statistical volatility to the extent those more aggressive allocations are consistent with the stated trust objective. On the other hand, trustees with overfunded policies should consider more conservative asset allocations to reduce portfolio risk albeit also with lower historical rates of return, again to the extent those more conservative allocations are consistent with trust objectives.
- **Sell, buy, or exchange policies.** In the same way portfolio managers sell investments that are no longer suitable, ILIT trustees should consider either (a) exchanging less-suitable TOLI policies in favor of more-suitable products that offer rates and terms more consistent with trust objectives, (b) borrowing from policy cash values and reinvesting proceeds in a manner that maximizes benefits to trust beneficiaries, or (c) selling existing holdings on the secondary market for a profit that is greater than the cost and repurchasing a policy with the same benefits on the open market.[6]
- **Wait and see.** If policy cash values are slightly above or below targets but investment performance is within expected ranges policy expenses are justified, and cash values and planned premiums are sufficient to support projected expenses for the foreseeable future, then ILIT trustees can consider a "wait and see" approach to changes in investment returns.

Remember that Section 9 of the act allows for a "prudent delegation" of these investment and management functions to an investment or insurance advisor who is qualified to perform these functions. Whether performed by an ILIT trustee or delegated to a qualified advisor, these management activities clearly involve new roles, responsibilities, and services for the ILIT.

SUMMARY

The good news is that the management process discussed above can produce a substantial increase in trust death benefits or reduced premium requirements for the same trust death benefit.[7] Either way, this represents a substantial cost savings (perhaps $4,000 for each $10,000 in premium) that the ILIT trustee can bring to his or her beneficiary.[8] Perhaps more importantly, following the process described in this article can keep an ILIT trustee out of trouble with his or her clients and beneficiaries.

Exhibit A: Pricing Factors for Various Insurance Products

Product Type	Premiums	=	COI Charges	+	Policy Expenses	–	Policy Interest/Earnings
Fixed-Duration Term							
Annually Renewable Term	Set by actuaries and guaranteed for a 1 year term that is generally renewable.	=	Not Disclosed	+	Not Disclosed	–	0 percent or Not Applicable
Level Premium Term (LT## where ## is the term of years)	Set by actuaries and guaranteed for a fixed term of years (e.g., LT10 = 10 yrs).	=	Not Disclosed	+	Not Disclosed	–	Not Disclosed
Flexible-Duration Term (Universal Life with Secondary Death Benefit Guarantees)							
Guaranteed Pricing* Set by actuaries and guaranteed for a fixed term of	years set by agent/broker or policy owner.	=	Not Disclosed	+	Not Disclosed	–	Not Disclosed
Nonguaranteed Pricing	Set by agent/broker or policy owner.	=	Usually disclosed, but generally greater than COIs for guaranteed pricing	+	Usually disclosed, but generally greater than expenses for guaranteed pricing	–	Usually disclosed, but generally less than interest for guaranteed pricing
Universal Life (Current Assumption Universal Life)							
Nonguaranteed Pricing*	Set by agent/brokeror policy owner to cover COIs and Exps for a specified duration	=	Usually disclosed and generally based on historical mortality experience	+	Usually disclosed and generally based on historical operating experience	–	Usually disclosed and based on performance of General Account of bonds and mortgages
Guaranteed Pricing	Calculated by agent/broker or policy owner from guaranteed COIs, Exps and i percent	=	Usually disclosed and generally set at maximum statutory limits	+	Usually disclosed and generally set at maximum statutory limits	–	Usually disclosed and generally between 3 percent to 6 percent
Variable Life							
Nonguaranteed Pricing*	Set by agent/broker or policyowner to cover COIs and Exps for a specified duration	=	Required to be disclosed and generally based on historical mortality experience	+	Required to be disclosed and generally based on historical operating experience	–	Required to be disclosed and based on performance of mutual fund like separate accounts
Guaranteed Pricing	Calculated by agent/broker or policy owner from guaranteed COIs, Exps and i percent	=	Usually disclosed and generally set at maximum statutory limits.	+	Usually disclosed and generally set at maximum statutory limits.	–	Usually disclosed and generally between 3 percent to 6 percent only for cash values allocated to general account.
Whole Life							
Nonguaranteed Pricing*	Min prem/yr set by actuaries, but payment duration set by agent/broker or policy owner	=	Generally not disclosed and instead included in proprietary dividend formulas.	+	Generally not disclosed and instead included in proprietary dividend formulas	–	Sometimes disclosed upon request and included in proprietary dividend formulas
Guaranteed Pricing	Set by actuaries at amount required to fully guarantee death benefits	=	Generally not disclosed and instead included in "tabular cash value" calcs	+	Generally not disclosed and instead included in "tabular cash value" calcs	–	Sometimes disclosed and generally around 4 percent

*Indicates the most common/prevalent form of policy pricing.

[1] See Section 277 of the *Restatement*, Comment e, page 23 and Comment b, page 11.
[2] See Section 2, Subsections (a) through (d) of the act.
[3] See Section 2, Subsection (d) of the act.
[4] *Restatement of Trusts* 2d Section 174 (1959) provides as follows: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."
[5] See "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustee and Advisors" in the February 2002 issue of *Trusts & Estates* magazine, as well as *Baker Boyeer Nat. Baond v. Garver* (Ash. App. 1986) 719 P. 2nd 583, 591, *Noggel v Bank of America* (Cal. App. 1999) 70 CA 4th 853, *Matter of Estate of Janes* (1977) 90 N.Y. 41 659 N.Y. S. 2nd 165.
[6] See page 2 of "The Two Headed Beast" in the April 2003 issue of *Financial Advisor* magazine.
[7] According to a CASCO survey reported in the April 1999 issue of *Trusts & Estates* magazine, TOLI death benefits can be increased by 40 percent or more, or TOLI premiums can be reduced by 40 percent or more in 65 percent to 85 percent of single life and survivorship trust owned policies respectively.
[8] Trustees can and should consider charging a fee for such services. For instance, if a trustee's regular compensation schedule for TOLI assumes that the trustee will serve only as custodian of TOLI policies, it should ordinarily follow that the trustee would be able to increase its fee when adding TOLI management services.

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Christopher P. Cline, a member of the Holland & Knight LLP Private Wealth Services team, practices in the area of estate planning and administration in the Portland office. He is a Fellow of the American College of Trust and Estate Counsel and has been listed as one of the "Best Lawyers in America". He is a frequent speaker and author on estate planning and charitable giving topics, and is the author of three BNA Tax Management Portfolios on various estate planning topics. He is the Past President of the Executive Committee for the Oregon State Bar Estate Planning and Administration Section, President-Elect of the board of the Estate Planning Council of Portland and vice president of the board of BodyVox, Inc., a prominent Pacific Northwest dance company.

Barry D. Flagg is founder of TheInsuranceAdvisor.com (TIA), a leading provider of life insurance product ratings and research. TIA is the natural outgrowth of his need to measure pricing and performance in managing portfolios of insurance products for affluent individuals and growth companies.

Mr. Flagg is a frequent speaker to industry groups and workshops for regional and national law and accounting firms, most recently speaking at the HSBC Bank/Wealth & Tax Advisory Annual Conference, the Grant Thornton Family Wealth Planning Annual Conference, and the National Financial Partners Semi-Annual Marketing/Continuing Education Conference.

Mr. Flagg has also been published in *National Underwriter* and *Agent's Sales Journal* magazines, and provides content to the InvestmentAdvisor.com Web site. He is a cum laude graduate of the W. Paul Stillman School of Business at Seton Hall University, and a member of the American Society of CLU and ChFC's, the Association of Advanced Life Underwriters, and the Beta Gamma Sigma National Scholastic Honor Society. He is also listed in Who's Who in Finance and Industry and has been recognized as an Outstanding Young Man of America. Reach him by telephone at (813) 908-8242 x313 or via e-mail at BFlagg@TheInsuranceAdvisor.com.

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