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A Guide to Evaluating Trust Owned Life Insurance (TOLI)

The major role of a life insurance trustee is the maximization of the value of the life insurance policy held in trust. There are times when the maximization of the trust may call for the replacement of the existing life insurance policy for one that is more appropriate and provides greater value to the heirs. Recent events in the capital markets have made the need to review the status of these life insurance policies even more critical. When that occurs there are many issues to consider. A prudent approach is to consider as many of the issues as possible before making any decision that may affect the eventual outcome of the trust.

There are special challenges associated with Trust-Owned Life Insurance (TOLI). Many of you are aware of the issues surrounding life insurance policy performance in the low interest and volatile investment climate we have weathered. The simple fact is that a good portion of life insurance policies sold in the last two decades have not performed as expected. At the same time lower mortality charges and more efficient product design have created a new generation of life insurance policies that can, in some situations, provide greater value for trust beneficiaries.

- For the professional trustee governed by The Uniform Prudent Investor Act (UPIA) there is a fiduciary process which requires that all assets, including life insurance, are deemed suitable for the specific trust goals and are reviewed periodically. It is critical in mitigating liability that the professional trustee have a process in place to review the trust assets and that the process be well documented and made a part of the trust file.
- There are also challenges for the non-professional trustee. While we can assume the professional trustee has some expertise in both TOLI product and administration, the same cannot be said of the non-professional trustee. Improper administration may subject the trust to scrutiny that can negate some of the benefits of the trust. Without the proper knowledge or ability to review a complicated asset like life insurance, policies managed by a non-professional trustee can often underperform and not reach their expected goal.

As previously mentioned the life insurance industry has undergone a transformation over the past two decades. Lower mortality charges, cost efficiencies and access to capital markets have allowed insurance companies to create new life insurance products that may provide a greater value to the life insurance consumer. If you are considering the replacement of a permanent life insurance policy with another, you must first be aware of the possible disadvantages of such a transaction.

- Your client may have to satisfy limits in the new policy that have already been satisfied in the old policy. For example, a life insurance policy has a two-year "incontestable" clause. With the purchase of a new policy, that clause would begin again.
- If the present policy has existing loans, the transfer of the policy values may have potential tax consequences. An outstanding loan is part of the policy's cash value. Your client should gain an understanding of this issue from a life insurance agent and also discuss this with a tax advisor.
- Even if the policy does not have a loan, there could be tax consequences. Generally, if you terminate a life insurance policy, there will be taxes due on the "gain" in the policy, which is defined as the difference between the surrender value (the amount received from the insurance carrier) and the cost basis (the amount of premium paid which includes any carry-over premiums from earlier contracts). We can help mitigate the tax consequences with the use of a 1035 Exchange, discussed on the next page.

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- Policies issued prior to June 21, 1988 may have tax benefits that are not available with the new policies. These older policies are not subject to the rules governing Modified Endowment Contracts (MEC). If the existing contract is a MEC and issued prior to June 21, 1988, you should gain an understanding of this issue from the life insurance agent you are working with and you should also discuss this with a tax advisor.

- The values in a newly purchased policy will differ from those in the replaced policy. New life insurance policies contain new sales and acquisition costs, and in the case of universal life policies, a new surrender charge period. So at any point in time the values may be more or less than what the values could have been in the replaced policy.

If you are recommending to replace an existing policy with a new policy based on a sales illustration that relies on "current assumptions" and non-guaranteed investment returns, please be aware of the following:

- **Life insurance sales illustrations contain guaranteed* and non-guaranteed elements.** The policy's non-guaranteed elements are projections of interest rates, investment returns, and mortality and cost assumptions that may or may not occur.

- **People are living longer. Costs and mortality charges in newer policies have been trending downward as market-driven cost efficiencies, advances in healthcare and new industry standards have come into play.** Most recent is the industry-wide adoption of the 2001 CSO tables as a pricing standard.

- **If the new policy is a Universal Life or Whole Life product, the policy values are based on insurance company's directed accounts. Those accounts are primarily invested in bonds and real estate and can include mortgages.** There may be an approximate 100-150 basis point difference between the actual returns obtained by the company and the amount credited to the policy. You can request information about the returns obtained and compare them to the amount credited.

If you are recommending to replace an existing policy with a new policy based on a sales illustration that relies on "guaranteed assumptions" understand that the policy guarantees will be only as strong as the carrier backing them. Review the ratings of the selected carrier against this listing of top ratings. A company's ratings should be monitored for changes.

There are a number of very valid reasons why an older policy should be exchanged for another policy.

- **Newer policies may have lower costs.** Many of the newer policies available today have cost structures that are lower than policies issued just a few years ago. The carriers tend not to pass these cost savings on to people with older policies (policies issued more than five years ago) – so those who wish to take advantage of the newer costs may need to purchase new, more efficient policies.
- **Changes in underwriting of the insured(s).** Sometimes, the insureds have favorable changes to their health that might affect the cost structure of the policy.
- **Underwriting opportunities.** Specific underwriting programs that "shave" undesirable ratings off the original underwriting offers may become available. These may reduce the mortality costs within the policy.

*Any guarantees mentioned are subject to the claims paying ability of the issuing company.

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- **Carrier financial difficulties.** If the financial stability of an insurer changes, it may be prudent to move to a more financially solvent company.

An Internal Revenue Code Section 1035 Exchange refers to a tax-free method of exchanging an existing life insurance policy for a new policy with a different company. A 1035 Exchange allows the contract owner to exchange contracts while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes. While each circumstance is different, and other conditions may apply, all policyowners should consider the following when contemplating a 1035 Exchange:

- **The owner and insured on the "new" contract must be the same as under the "old" contract.** However, changes in ownership may occur after the exchange is completed.
- **Two or more "old" contracts can be exchanged for one "new" contract.** Multiple contracts that can be exchanged for one contract as long as the insured, the beneficiary and the policy owner are the same.
- **The adjusted basis of the "new" contract is the total adjusted basis of all contracts exchanged.** The death benefit for the "new" contract may be less than that of the exchanged contract, provided that all other requirements are met.
- **You cannot exchange a second-to-die policy for a single-life policy or vice versa.** However, the IRS has provided guidance in two Private Letter Rulings which allowed the exchange from a second-to-die policy to a single life policy after the death of one of the insureds (PLR 9248013, PLR 9330040).
- **Under certain circumstances you may exchange a contract with an outstanding loan for a "new" contract**. This depends on many factors such as the size of the loan as compared to the policy's cash value and whether or not the insurance company issuing the "new" contract will allow it. Not all insurance companies will allow this.

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