Oversights & Inconsistencies Exposed by Insurance Reviews

Carrier Financial Strength

- The carrier's financial ratings are declining or considered "vulnerable" by insurance carrier rating agencies (A.M. Best, Standard & Poor's, Moody's, etc.)

Performance

Life insurance policies should be reviewed every few years to avoid unanticipated consequences.

- The policy is projected to lapse earlier than expected unless higher-than-scheduled premiums are paid. Given market performance, this has been a common theme-even when no errors are made!
- The "as issued" illustration for a single-pay policy that was "back-dated" 5 months assumed that substantial Section 1035 Exchange proceeds would be applied to the policy on the policy issue date. In reality, the 1035 proceeds were applied to the policy 6 months after the issue date; as a result, an inforce policy illustration, generated one year following the issue date, illustrates that the policy may lapse four years earlier than shown on the "as issued" illustration and two years after life expectancy.

Owner/Beneficiary Issues

- **Trust is dated after the insurance application and there are no notes in the file that the application was back-dated to "save age."** (If the insured dies within 3 years of the policy date, the death proceeds may be included in the insured's taxable estate.)
- **Insured's estate is named the beneficiary of a significant amount of life insurance**. This subjects the proceeds to state and federal estate taxes and makes it certain that creditors have full access to the life insurance proceeds.
- **There are no contingent beneficiary designations.** If the sole beneficiary predeceases the insured/policyowner (even if only by minutes) and no change was made to the beneficiary designation, the proceeds will be paid to the insured's estate (and will be subject to state and federal estate taxes).
- **Policy proceeds are payable outright to minor children or grandchildren or to handicapped or emotionally immature or financially irresponsible individuals.**
- **The beneficiary of business-owned life insurance is the insured's personal beneficiary.** In this case, when the death benefit is paid, it is taxable as ordinary income to the beneficiary and may or may not be tax-deductible by the business. (There are a couple of different ways this can be fixed, but the problem can't be fixed without a tax cost . . . so all options should be considered.)
- **Wife owns a policy on her husband's life and names their children as beneficiaries.** At the husband's death, the wife is deemed to be making a taxable gift in the amount of the death benefit to the children.
- **An Irrevocable Trust is designated as the Policy Owner and Beneficiary, yet no such trust exists.** This happens when the insurance agent rushes the client's attorney for the name and date of the trust for application purposes but then there is no follow-through to assure the trust has been executed and the insurance carrier's records are updated.

Global Citizen Issues

- **Client/ Insured owns a life insurance policy and has named a U.S. revocable trust as the beneficiary. The client/ trustee has moved to the U.K. for a job assignment for the next three years.** This causes the trust to be a UK resident trust for UK income tax purposes and subjects the trust to UK income tax – currently 45%.

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Underwriting Discrepancies

- Universal life policy was issued on a "non-preferred basis" or as a "smoker" risk, while other policies issued at the same time or thereafter were issued on a "preferred non-smoker basis."
- Insured's age in the universal life policy is three years older than the insured's age on the "as issued" insurance illustration. This means that the mortality charges will be higher than illustrated and the policy will lapse when the insured is at least three years younger than projected.

Discrepancies in Insurance Carrier Records

- **"Cost basis" in carrier records is significantly understated** since the agent did not confirm the new carrier's receipt and recording of the replaced policy's basis. (This may cause significant unnecessary income taxes upon lifetime distributions of policy values. This is a recurring problem for both annuities and life insurance policies.)
- **Trust document date doesn't match the Trust date in owner & beneficiary designation on file with the insurance carrier.** (This causes administrative headaches at the time of a death claim.)
- **Collateral Assignment and Endorsement Problems.** Policy is subject to a Collateral Assignment, yet there is no collateral assignment on record at the carrier. Or a Split Dollar agreement references a collateral assignment, but the carrier's records indicate an Endorsement Split Dollar Arrangement.

Errors can be costly.

Some may not be discovered in time to be corrected.

Suitability

- **Variable Life Insurance.** "As Issued" variable universal life policy illustration assumes an 8.0% gross hypothetical rate; yet the cash value has been allocated for years to a fixed account, or worse yet, a money market account.
- **Single Life vs. Survivorship Policy.** Husband and wife who have been happily married for over 40 years need life insurance to pay estate taxes. Both are in excellent health. They established a Trust and the Trust bought a whole life policy insuring the husband. A survivorship policy, jointly insuring both spouses with a death benefit payable upon the death of the survivor-insured (i.e., when estate taxes are most likely payable) may be more suitable. Generally, a survivorship policy will provide fifty percent more death benefit for the same premium.

Product Structure

- A Universal Life policy has a loan outstanding and payments are being applied as premiums rather than as loan principal payments and/or interest payments. Premium payments are reduced by taxes and commissions before they are applied to the policy's account value. If the same payment was applied as a loan repayment, 100% of the payment would be applied to the policy's account value.
- Whole Life policies. The policyowner is no longer paying premiums in cash since he was told the premiums would "vanish." He doesn't realize that the dividend scale has reduced and the annual dividends can no longer pay the premium due; therefore, there is a loan on the policy since premiums are being borrowed. (Policy loans reduce the net death benefit and hinder policy performance.)

Products

- **Waiver of Premium Riders**. Client, a successful litigation attorney, owns a whole life policy with a waiver of premium rider; the cost of the rider is over $2,800 per year. The definition of disability in the waiver of premium rider defines "total disability" as unable to do the main duties of his/her "occupation;" "occupation" means the insured's regular

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occupation at the start of disability. After 24 months, "occupation" means any occupation for which the insured is or may become qualified as a result of training, education or experience. (This means that the premium will mostly not be waived if the insured can work in any legal profession, even though his income may reduce significantly as a result of his disability. Note: Most waiver of premium riders are not cost-efficient; this risk is more efficiently and more cost-effectively insured through disability insurance.)

- **Term Products.** The Term policy's conversion period has expired and the client (who is now uninsurable) was not informed beforehand of his option to convert to a permanent product.
- **Guaranteed UL (GUL) Products.** Carriers state that the death benefit is guaranteed for a specified number of years provided the premium is paid "when due;" however, each carrier defines "when due" differently! The guaranteed period for some GUL products reduces even if the premiums are paid before or on the due date!!! Therefore, we suggest running inforce policy projections to confirm the guaranteed duration after every premium is paid. Note: This problem is especially troublesome since GUL policies have insignificant cash values and therefore, are not easily replaced.

Split-Dollar Arrangements

- The Split-Dollar Agreement has not been reviewed since September 17, 2003.[1]
- The agreement was changed since September 17, 2003, which caused a "material change" and thus, the split dollar "grandfathering" has been lost.[2]
- The Return of Premium rider dropped off the policy at the time of the expected "rollout date." Therefore, if the insured dies, there won't be enough death benefit to repay the Company and the insured's family what they are expecting.

Transfer for Value

- Client's brother bought a life insurance policy years ago and can no longer afford to pay the premiums; therefore, the client bought the policy from his brother and named himself as owner and beneficiary. This is a transfer for value, making death proceeds in excess of the purchase price (plus premiums paid after the purchase) subject to income tax.

Trust Administration

- An irrevocable trust is the owner and beneficiary of a life insurance policy insuring the trust grantor. The premium payments are paid via checks drawn from the grantor's personal checking account (rather than from the trust checking account). Best practices are not being followed for premium payments (e.g., Crummey notices, gift-tax reporting, etc.). This may cause the policy's death benefit to be included in the grantor's taxable estate.

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[1] Effective date of the "Final Split-Dollar Treasury Regulations". The "Final Regulations" refer to Treasury Decision 9092 that provides comprehensive Final Regulations (under§§ 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-l(q), and 1.7872-15 of the Income Tax Regulations) regarding the federal income, gift and employment taxation of split dollar life insurance arrangements (as defined in § 1.61-22(b)(l) or (2)).

[2] There may be limited grandfathering pursuant to Notice 2002-8 for arrangements entered into before January 28, 2002.