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Keep Tabs on Insurance That Covers Estate Tax

By ARDEN DALE

Using life insurance to cover the death tax is common practice, but the strategy is blowing up some estate plans now.

The policies are imploding because of low interest rates. An insurance plan issued years ago, when interest rates were higher, may no longer be earning the investment returns it needs to pay premiums as drafted. That shortfall leaves the owner on the hook for unexpected costs.

If the worst happens and a policy collapses, its demise can even result in a big tax bill.

Estate planners are noticing the problem. (It is hardly limited to their arena. A policy can lapse no matter what it is used for.) Some expect it to get worse.

Donald Walters, general counsel for the Insurance Marketplace Standards Association, said IMSA has heard anecdotally of "growing concern" about troubled policies. The group is a nonprofit that develops best practices for the insurance industry.

Insurance consultant Bill Boersma, the founder and president of Opportunity Concepts in Grand Rapids, Mich., said he has worked with many troubled policies recently. He predicts a "tsunami" of lapses over the next few years.

"The worst are going to be from the 1980s and 1990s, when interest rates used for the projections were higher," said Mr. Boersma, who sees most trouble with universal and variable-life policies, although whole-life policies are starting to fail "at an alarming rate."

Problems stem largely from expectations about how well investments in a policy will perform. A policy may have been set up to self-pay premiums, based on the notion that investments will beat the interest rate used. Money then builds up and pays the premiums automatically.

But if interest rates decline over time, trouble can occur. The owner may not be aware that the policy is taking out internal loans to keep up with the premium payments.

Indeed, a lapsed policy often comes as a shock to its holder. Many assume the insurance is paid up or on automatic pilot so that they won't owe anything more out of pocket.

Jere Doyle, senior vice president at BNY Mellon Wealth Management, says he hasn't yet seen lapsing policies. But he says people do need to know that, if a policy doesn't perform as projected because of lagging investment returns, "the insured will have to pay the premium out of pocket longer than expected or for the duration of the policy."

Policies can be structured in many ways, and how the terms are laid out can determine a holder's liability. Knowing those terms is critical.

Advice to those using life insurance in an estate plan: Have an attorney check on the health of the plan. And don't be surprised if that person turns the matter over to an independent insurance expert. Policies are complicated enough that an estate planner or attorney may not feel comfortable vetting them.

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