Published by the
Estate Planning
and Administration
Section of the
Oregon State Bar

Newsletter

Oregon Estate Planning
and Administration
Section Newsletter
Volume XXXVII, No. 2
April 2021

Oregon State Bar
Estate Planning
& Administration
Section

Stress Testing Life Insurance

By James D. Pitman
Insurance Specialist, Insurance Consulting Services, Inc.

Estate planning attorneys have a tenuous relationship with life insurance. It does not tend to be a subject about which attorneys know very much, due in part to the fact that life insurance professionals sometimes seem to speak a different language full of industry-specific terms. Yet life insurance is often an important asset in a client's portfolio, and attorneys often draft trusts designed to hold life insurance specifically.

In recent years, life insurance has become a more problematic asset. By some estimates, 40% of trust-owned life insurance policies will lapse before the end of the insured's life expectancy. Further, 70% of those policies haven't been reviewed for five years or more. This is due in part to the large agent turnover in the insurance industry, resulting in a great many policies not having an active agent assigned to them.

Further, interest rates have been declining in the U.S. for the past 20 years. While this may be great for your client's mortgage, it is not so great for their permanent life insurance policy. When the industry unbundled whole life insurance in the early 1980s and created universal life insurance, it gave the agent and client the opportunity to design individual products. The drawback to this, however, is that life insurance illustrations assume the current interest rate will remain the same over the life of the contract.

As life insurance products are built on interest rate assumptions, the policy reserves often aren't being adequately funded in today's low-interest environment. Twenty years ago, it was reasonable to assume an 8% rate of return on a life policy. But today, those policies are getting a 3% return. It could take three to four times the premium to fund the policy to life expectancy. And insurance companies don't provide automatic review processes with in-force illustrations.

How should estate planning attorneys address this problem? One approach is simply to avoid the issue, by deciding that it is not part of the estate planning attorney's job. This is not an unreasonable position; however, even if an attorney decides it is outside the scope of his or her work, he or she should at a minimum point out the disturbing information above and encourage the client to speak to the agent assigned to the policy (or ensure that a new agent is assigned to it). This is particularly true for those clients for whom the attorney has drafted life insurance trusts.

For the attorney who wants to become more involved in helping a client analyze his or her insurance position, consider the following steps:

- Ask clients with an in-force life insurance policy why they originally bought the insurance.

In This Issue

1 Stress Testing Life Insurance
2 Some Thoughts About Trust Distribution Provisions
6 Events Calendar

- If it still aligns with their current needs, help the client ensure that an active agent is assigned to the policy. An active agent will help obtain the information described below.
- Have the client request an in-force ledger from the insurance company to determine if the policy is in good standing. He or she will get an idea of what the performance projection looks like going forward and how it will perform if the client continues to pay what they're currently paying.
- If the policy is underperforming (that is, if it is not projected to last for the client's life expectancy), help the client determine how much they should increase premiums in today's lower interest environment. If paying more premium is not a viable option, consider reducing the death benefit to match their current premiums.
- Conduct a similar review process every three to five years.

Also, if the client needs to increase premium payments to adequately fund a policy, make sure the agent explains why, and shows what the numbers look like if the client wants to keep the policy in effect through maturity.

One of the worst mistakes a client can make is holding onto an inadequately funded policy for 10 or 20 years. By that point, the policy is vastly underfunded and has decades less compounded interest to build that shortfall. If you establish a review process with any new clients and an ongoing monitoring process with existing ones, you'll help ensure your client's policies are adequately funded throughout their lifetime. It is a great way to demonstrate your breadth of knowledge to a client beyond the estate planning law.

Some Thoughts About Trust Distribution Provisions

By Christopher P. Cline
Riverview Trust Company

Drafters of trusts have so much to think about: trust protectors, trustee succession, governing law, tax clauses, estate and gift tax issues, protection from creditors. It is an incredibly complex and difficult task, and many of us have spent long careers trying to perfect that craft. It is strange, then, that the most controversial area of drafting sometimes seems to get the least amount of attention.

Beneficiaries only care about two things: how much do I get and when do I get it? All of the other drafting issues mentioned above matter only to the extent that they affect the answers to those two questions. Yet trust drafters often devote only one paragraph out of a 20-, 30- or even 50-page document to trust distribution language. And too often, even that language is standardized: "all income, principal for standards." This language has become the industry standard for so long that its usefulness or appropriateness is never questioned. But as any trustee can tell you, it can often lead to trouble between beneficiaries, or between a beneficiary and the trustee.

This article will attempt to redirect our thinking about trust distribution language. It will start by discussing the nature of such language, breaking it into either "objective" or "subjective" categories. It will discuss the pros and cons of each category, and present ways of thinking differently about them. Next, it will provide some practical alternatives to standard distribution language. Finally, it will discuss the importance of "purpose" language.

(Parenthetically, this article is also a sneak preview of a presentation that the author will give at the Oregon State Bar Advanced Estate Planning continuing education seminar in June. We are all about cross-selling here at the newsletter!)

I. Objective or Subjective Distributions?

The universe of trust distribution provisions can be divided into two large subsets: subjective and objective provisions. Since the only provisions that most beneficiaries care about are those that deal with what they get and when, reviewing the pros and cons of these two types with clients is very useful.

Objective Terms

There are generally two groups of objective trust terms: income-based and incentive-based. The income-based terms are the traditional group most estate planners are familiar with; under this model a beneficiary is entitled to all the income from the trust. There are a couple of modern offshoots, the unitrust and the adjustment between principal and income. Both, however, are based on the traditional notion of "all income," but with modifications to take into account the mandates of modern portfolio theory.

The second group, incentive trusts, gained popularity over 20 years ago. Indeed, a 1999 article in the Wall Street Journal discussed their use.[1] The article actually mentioned several incentive trust provisions, which are illustrative of the type of provisions common to the trust: matching earned income up to a specified amount; distributing a fixed amount for the beneficiary to start a business or

1 *Cited in* Stephens, *Incentive Trusts: Considerations, Uses and Alternatives*, 29 ACTEC Journal 5 (Summer 2003) (hereinafter "Stephens"). *See also* McCue, *Planning and Drafting to Influence Behavior*, 34 U. of Miami, Phillip E. Heckerling Inst. of Est. Plan. (2000) (hereinafter "McCue").

professional practice; making a monthly payment for a "stay-at-home" parent; denying distributions if the beneficiary fails a drug or alcohol test; and making fixed distributions for each year in which a beneficiary has no driving violations.[2]

Such provisions have some superficial appeal and (at least in the case of drug testing) may be critical in caring for a beneficiary. They encourage or discourage positive or negative beneficiary behaviors. They are also easy to administer: show me your W-2 and I will give you the money, pass your drug test and I will give you the money. They leave no room for a trustee to be over-indulgent.

However, objective provisions also have serious problems. The traditional "income only" provisions are virtually useless in most settings, because they bear no relation to any goals that the grantor might have. The income might be too much or too little for purposes for which the trust was created. The same is true for unitrusts and for income with the trustee's ability to adjust between principal and income: neither relates to real-world client goals for the beneficiary. They are often as not short-hand solutions suggested by the drafter.

One variant of the "income-only" model has some relevance to real world goals, and that is the dollar amount, adjusted for inflation. For instance, the beneficiary is to receive $100,000 per year, adjusted for inflation. This type of provision allows the grantor to establish a standard of living by creating essentially a salary from the trust. Inflation adjustment is obviously critical in this context to ensure that the beneficiary does not lose pace to inflation over time. Note that, even in those cases when an "all income" provision is required (for example, in the case of QTIP trusts), a "greater of" provision can be used (i.e., the beneficiary shall be entitled to the greater of all net income or the inflation adjusted dollar amount).

Another problem with objective provisions is that they cannot adapt to the needs of a particular individual. For example, by promoting a daughter to stay at home with her children, they might discourage her developing her natural abilities in other areas. Further, by simply encouraging higher earnings, the trust terms might convince a beneficiary who wanted to be a schoolteacher to be a lawyer instead. To take this notion further, a document that specifically provides for one thing specifically excludes another. Behaviors not specifically set forth, but which may be equally desirable, are not accounted for.

A third problem is that objective provisions, which are fundamentally restrictive, do not allow for changing circumstances. The beneficiary who develops a debilitating illness that prevents her from earning at prior levels, for example, may find herself impoverished if the trust is not drafted broadly enough. In a more general sense, anyone who drafts a long-term trust with specific, objective terms, believing he knows what the world will look like 20 or 50 years from now, is probably thinking too narrowly.

Finally, and most importantly, a grantor who creates an incentive trust that focuses on behaviors usually doesn't seek to promote those behaviors per se. Instead, the grantor seeks to promote something that the behaviors represent. For example, a client is not really trying to encourage W-2 income, but rather productivity; entrepreneurship is ultimately less important than "independence, ingenuity and innovation."[3] In other words, the grantor identifies certain behaviors that are a surrogate for maturity and drive. But by naming surrogates rather than the thing itself, the grantor runs the very serious risk of missing the mark altogether: a "teacher of the year" might receive smaller trust distributions than a mediocre lawyer.

Subjective Terms

If objective provisions are inadequate, does that mean that we should favor subjective instead? Subjective provisions are those that require the exercise of discretion by the trustee in making certain value judgments. For example, the subjective standard most of us are familiar with is the trustee's ability to distribute principal for "health, education, maintenance and support." The trustee must decide what constitutes "support," which could include living in anything from a shack to a mansion. This flexibility is seen by many as a significant benefit. At least one commentator has noted that objective, "incentive" provisions are not the solution to most family relationship problems, and so should not be the "first weapon out of the arsenal."[4] Indeed, the incentive trust works best "in the most desperate situations" (as an alternative to disinheritance for a beneficiary engaging in anti-social behavior, for instance).[5] Discretionary trusts "should be seen as generally preferable to incentive trusts" because of the increased flexibility.[6]

However, if a discretionary trust is to be used, several additional provisions should be added. First, the grantor should give clear guidance as to the exercise of the discretion. The grantor's intention "should be set forth in sufficient detail to tell the trustee what the [grantor] really wants."[7] Further, trustee exculpation should be added, including perhaps provisions that set forth how the costs of litigation are to be paid (such costs may be assessed against the beneficiary who brought it, for example).

2 *Id.*

3 *Id.*

4 McCue, supra note 1, at § 609.2.

5 *Id.*

6 *Id.* at § 609.3.

7 *Id.*

These measures will ensure that the trustee will exercise discretion in a manner as close as possible to that the grantor intended, with less fear that he or she will be sued for doing so.

Finally, even if such provisions are added, some problems remain. First, the more discretion given to the trustee, the greater the likelihood that the trustee will exercise it in a manner the grantor would not have agreed with. This may not be all bad, by the way. Second, discretion guarantees only flexibility, not success.

II. Ways of Thinking About Drafting.

Don't Use "All Income."

There are few habits in trust drafting as thoughtless and counterproductive as giving a beneficiary "all income." Excluding the few times when it is required (in QTIP trusts, for example), there is no reason to give a beneficiary all income. It has no relation to any real world goal, and pits beneficiaries against each other, because the trustee's investment choices benefit one beneficiary over another.

Honestly, "all income" just makes no sense. The only solid argument in favor of an "all income" standard is that it's better to pass income out to the beneficiaries so that they can pay at their (often) lower income tax rates than to retain the income in the trust and pay income tax at the compressed (and typically higher) trust rates. But such an approach means giving the beneficiary a potentially larger distribution than is appropriate, simply to reduce the overall amount of tax paid. This could be argued as being simply a case of "the tax tail wagging the dog" (although there is room for argument on both sides).

But if "all income" doesn't make sense, what does?

Consider an Inflation-Adjusted Dollar Amount.

If "all income" is the most overused distribution provision, the most underused is the inflation-adjusted dollar amount (e.g., "beneficiary shall receive $75,000 per year, increased in each year by CPI"). No client knows how much "all income" will buy in the future, but everyone knows how much $75,000 per year in today's dollars will buy. Using this standard makes principal distributions easier to draft as well, because there will be less need for "support" or "maintenance" if a minimum standard has been applied.

Consider a Unitrust.

If the inflation-adjusted dollar amount is too radical for you, at least consider the unitrust distribution. This has two benefits over "all income": the trustee can invest for total return, and not income production, and the percentage can be fine-tuned more than "income" can.

Add "Standards" Preferences to All Trusts.

A great many, probably most, irrevocable trusts allow for distributions of principal for a beneficiary's "health, education, maintenance and support." However, not all of these standards necessarily are created equal. Is education more important than other purposes, for example? Clarity about standards is not often included, but many grantors do have strong feelings about priority. This tip is especially useful with the inflation adjusted dollar amount. In that case, education and medical care would likely be emphasized over support or maintenance.

Be More Specific About What the Standards Mean.

For too long we've blindly referred to "health, education, maintenance and support," for no good reason other than they're included in the Internal Revenue Code. Consider the following:

First, why do we even use "maintenance" and "support" when the Regulations state clearly that they are identical terms? This is not a substantive issue, but rather evidence that we've tended to gloss over the issue.

Second, paying for a beneficiary's support can often be contrary to not only the grantor's objectives (most grantors want their beneficiaries to be productive) but also the factors that tend to create long-term beneficiary happiness (there is much evidence to support the idea that self-sufficiency is more important to overall happiness than more money). Of course, there are plenty of circumstances in which support is appropriate (when a beneficiary is attending college, for instance, or for a surviving spouse who has spent her life working in the home). But the number of times that the term is actually used probably outweighs the number of times it's appropriately used.

Third, broaden "education" to include things like personal enrichment classes and courses that lead to professional designations. Such courses may help with the beneficiary's personal growth and are unlikely to sap a beneficiary's incentive.

Fourth, distributions for "health" should almost always be added, and might be expanded to be clear that the trustee can pay insurance premiums and perhaps also reimburse employee co-pays for such insurance. While we're on the subject of insurance, by the way, "health" might also include payment of insurance premiums for disability, AD&D and perhaps even long-term care or life insurance designed to replace the income of the working spouse in the event of her death (being mindful, of course, not to create any "incidents of ownership" problems).

Realize That "May Look to Other Resources" Really Means "Shall" Look to Them.

Many trust agreements state that the trustee "may" consider other resources when considering whether to

make discretionary principal distributions to a beneficiary. However, when considering the trustee's undivided duty of loyalty to both current and remainder beneficiaries, a strong argument can be made that a trustee with the ability to consider other resources should always do so. For this reason, most if not all corporate trustees consider "may" in this context to mean "shall."

This is not merely a corporate trustee issue, however. Attorneys advising individual trustees should probably counsel those trustees to take the same position. A trustee who has the ability to take into account other resources but does not do so opens herself up to potential liability exposure to the remainder beneficiaries for spending too much trust money needlessly. On the other hand, it seems unlikely that a current beneficiary would have grounds to pursue the trustee for not making distributions to that beneficiary when she already had sufficient resources of her own.

III. Purpose.

One final factor that doesn't directly address the size of distributions but that can have a huge impact on the trustee's and beneficiary's perspectives toward distributions is "purpose" language. Purpose in a document gives the beneficiaries and trustee knowledge about why the trust exists. Failure to define purpose is one of the biggest drafting flaws because it allows the beneficiary to say, "but Mom always wanted me to have ______" (fill in the blank with bigger distributions). In fact, most planners would acknowledge that this is so.

However, even though we might recognize its importance, most drafters still don't seem to use "purpose" language. This has been a historical problem. Over 50 years ago, the Oregon Supreme Court noted that

> "[t]he difficulty in many if not most of these [abuse of trustee discretion] cases is finding the purpose of the settlor with sufficient definiteness to be helpful . . . . The settlor's specific design in framing a discretionary trust is normally unexpressed or vaguely outlined."[8]

Two years later, Professor Edward C. Halbach, Jr., repeated those sentiments:

> "[t]oo frequently trust instruments provide no guidance as to the purpose and scope of the [discretionary] power. Although determining and assisting in the formulation of the donor's intentions is a primary counseling function, it is apparently one of the most neglected aspects of estate planning. A poorly defined discretionary power often results."[9]

The challenge with purpose language, of course, is that it risks becoming too "touchy-feely"; that is, the language is either too vague or too particular to resolve distribution questions.

Nevertheless, regardless of the purpose for which it is intended, any trust can benefit from a clear statement of the grantor's intent. This is the area of drafting most overlooked by lawyers, and also potentially the most critical to the success of a trust administration. Such language should be included in a separate paragraph, so that there is no risk of a trustee or a court confusing precatory purpose language with distribution language.

One further "purpose" provision that would generally be useful is a statement of beneficiary preference. That is, a separate paragraph that states which beneficiary's interests are to be considered more important than another's. For example, is this a trust primarily for the benefit of the current or remainder beneficiaries? Should one class be favored over another? Take the case of a trust for the benefit of a second spouse during that spouse's lifetime, with the remainder passing to two children from a prior marriage. If the spouse does not have significant assets in her own name, the trust might state that her interests are superior to those of the children. On the other hand, if the spouse has significant assets of her own, the trust might be considered a "backstop" only, to be used if the spouse's assets run out. In this case, the beneficiaries with the more important rights are the children.

Although this is sometimes very hard for a grantor to deal with, if such expressions of preference were used more frequently, many trust disputes would be resolved more quickly (to the extent that they are ever resolved at all).

* * * * *

Trust drafting is always challenging because the law seems to always be changing under our feet. But the biggest challenge in trust administration, determining how much and when to distribute to beneficiaries, is constant and unchanging. Hopefully, this brief article can help trust drafters to make this challenge a little easier for their trustees.

8 *Rowe v. Rowe*, 219 Or. 599, 606; 347 P.2d 968, 972 (1959).

9 Halbach, P*roblems of Discretion in Discretionary Trusts*, 61 Colum. L. Rev. 1424, 1434 (1961).

Oregon Estate Planning and Administration Section Newsletter

Editorial Board

Lisa Allen
Susan B. Bock
Janice Hatton
Melissa Lande
Philip N. Jones
Timothy R. Strader
Vanessa Usui

Questions, Comments, Suggestions About This Newsletter?

Contact: Chris Cline, Editor-in-Chief
(360) 759-2478, chriscline@riverviewbank.com

Disclaimer

The articles and notes in the Oregon State Bar Estate Planning and Administration Section Newsletter may contain analysis and opinions that do not necessarily reflect the analysis and opinions of the Newsletter Editor-in-Chief, the Editorial Board, the Estate Planning Section Board or the membership of the Estate Planning Section. It is the responsibility of each practitioner to perform their own research and analysis and to reach their own opinions.

Events Calendar

Advanced Estate Planning and Administration

Virtual CLE Program
Friday, June 4, 202

Co-sponsored by the Oregon State Bar and the Estate Planning and Administration Section

The Editors want to include announcements of upcoming events that are open to the public and may be of interest to our readers. If you know of an event, please send basic information, including point of contact information to Chris Cline at *chriscline@riverviewbank.com* for inclusion in the next issue of the Newsletter.