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By Arden Dale

Insurance policies are often used in estate plans to protect a fortune from creditors or to cover future taxes, but some are now threatening to fail.

The market shock of 2008 set in motion a chain of adverse effects in some variable life insurance policies, which invest their cash value in baskets of mutual funds known as separate accounts. The damage is only now starting to surface for policy holders and the outcome can be startling — and expensive.

Someone who has paid, say, $2 million into a policy over the years may suddenly learn he will lose the full cash value and get no death benefit in the end. The insurance company may send a notice requiring more money, and fast — within just 30 or 60 days — to keep the policy alive.

William Faranoz

Insurance used for estate planning purposes is often held in an irrevocable life insurance trust, or ILIT. Trustees can be individuals or trust companies, and may be a family member, advisor or estate planning attorney. Some don't closely monitor performance of the insurance policy investments.

The trustee may simply collect checks from the creator of the trust and pay the insurance premiums. Those premiums are paid as gifts into the trust, which is held outside the estate, and later the tax-free proceeds can be used to pay estate taxes. Another reason to put insurance into a trust is to protect its value against potential creditors.

Michael A. Mingolelli, Jr., chief executive of Pinnacle Financial Group, in Southborough, Mass., says annual reviews of these policies can help catch

problems before they become disasters. But often this isn’t done, he says. Salvaging a policy with a modest account value may be possible, but if enough time has passed that a lot of cash has built up, it is very hard to come up with the amount of money to keep the policy.

Mingolelli says he has recently helped a number of wealthy clients deal with policy problems and expects to see more.

Volatile markets can undermine a variable life insurance policy and did just that to many of them after 2008, according to John Resnick, whose Harrisburg, Pa., firm provides life insurance to high-net worth clients. He also lectures on life insurance at the Wharton School at the University of Pennsylvania.

Many policy holders are only feeling the effects now because the plans’ design can create a delayed reaction. A drop in cash value, together with rising mortality fees and expenses, will drain funds designed to sustain the death benefit.

Once the cash value goes to zero, “the policy will implode without value unless a much higher premium is paid,” says Resnick. Problems get worse as the insured gets older because mortality charges go up annually.

Edward F. Koren, chair of private wealth services at Holland & Knight in Tampa, Fla., also recently helped a client deal with a troubled policy. Because the policies are complicated, he says, an estate adviser should turn to a very good insurance agent for help.

“You need someone who deals with insurance every day,” says Koren.

Arden Dale is a Dow Jones columnist who writes about tax and estate planning. Her columns are available to Dow Jones Adviser subscribers.