Tax Planning with Life Insurance

William L. Haas
The Tax Reform Act of 1986 maintains the importance of insurance for risk protection and it enhances its value for savings, investment, and tax purposes.

1. Tax reform as it relates to the insurance company and product had been significantly addressed by TEFRA in 1982 and DEFRA in 1984. The industry was able to escape the most threatening reform proposals suggested for 1986 legislation.

   a. The most important proposal threatening the industry was to impose a tax on inside build up of cash values. This proposal was defeated. But changes in the area are still anticipated.

   b. The most threatening proposal which was enacted was probably the limitation on interest deduction for financing insurance.

2. The 1986 legislation adversely affected products which directly or indirectly competed in markets where the insurance product is now anticipated to make major inroads.

   a. Traditional tax shelters offering current deductions appear a thing of the past. Interest, therefore, shifts from current deductions to opportunities for deferred growth, an area where life insurance can excel due to the absence of the current taxation on the build up of life company reserves.

   b. Restrictions on qualified and non qualified deferred compensation will heighten the interest in alternative deferral vehicles. Similarly the elimination of preferred rates on capital gains will heighten this interest and new rules restricting income shifting trusts or uniform gift to minors act accounts will also focus interest on insurance.
e. By 1986 insurance company products have become very competitive in vying with banks and brokerage houses for the investment dollar. Included is a chart showing the investment results of one major company's allocated account for qualified plans during the ten year period culminating December 31, 1985.

d. Competitive rates for guaranteed investment contracts at the time of this writing September 1987 approximated. Note: Guaranteed investment company contracts do not fall under that provision of insurance law which classifies reserves as a deduction for insurance taxation purposes.

e. Included are some net rates applicable to single premium whole life and preferred annuity contracts.

I. Income Tax Issues

A. Life Insurance

Question 1: What are the advantages and disadvantages to a contract being labeled by the tax law as a life insurance contract?

Advantages:

1. The death benefit of a life insurance contract are excluded from the recipients gross income for income tax purposes. IRC Section 101a.

2. The cash value of a life insurance policy builds without current taxation. Three theories have been advanced: IRC Section 72; the constructive receipt doctrine; unrealized appreciation of a capital asset.

3. Section 1035 provides for the tax free exchange of a life insurance policy for another policy, an annuity, or an endowment, thus providing an element of flexibility to money contributed to a life contract. But Section 7702f7, as introduced in 1984, which will be discussed shortly, presents a real problem where cash is withdrawn before the maturity of an interest sensitive life policy, where a policy subject to a loan is exchanged or where in the exchange the benefits of an interest sensitive policy are reduced.
4. The benefits just stated as 1 through 4 above, apply to life insurance contracts, not to other forms of investment.

**Disadvantages:** (of being labelled life insurance)

1. Because its cash value built on a tax deferred basis, to the extent a life insurance contract could offer investment characteristics, it offered competitive advantage to products offered by the banking and brokerage industries. Diligence can be anticipated from these industries in bringing offensive contracts to the attention of the regulatory authorities; if a contract is found not to be life insurance a tax is triggered on its owner on the prior build up of cash value.

2. The definition of life insurance has been clarified with 1986 tax reform. The power of the Service to make new law in the area was greatly reduced but the invitation for a company to slip in its inherent definitional requirements is still a real danger.

3. In the future, insurance companies may anticipate having significant SEC compliance burdens including registration as a broker/dealer, investment advisor, and membership in the NASD. This is because most future life insurance policies are expected to be variable life.

**Question 2:** What section of the Internal Revenue Code permits life insurance company reserves to accumulate tax free? What tax provisions prevent the tax free build up of these insurance cash values from being presently taxable to the policy owner?

To qualify for taxation pursuant to Part 1, Subchapter L Chapter 1 of the Code (Section 801-818), a life insurance company must issue life insurance contracts, annuity contracts, or noncancellable contracts of health and accident insurance and more than fifty percent of its reserves must be life insurance reserves (which includes by definition reserves for noncancellable and guaranteed renewable accident and health insurance.) Life insurance reserves as defined in 3816 are listed as a deduction at 8805 from Life Insurance Company Taxable Income as computed pursuant to S801.
The cash value of a life insurance policy builds without current taxation to its owner. Three theories have been advanced. Section 72 IRC, the constructive receipt doctrine, unrealized appreciation of a capital asset.

**Question 3:** What is a Life Insurance Contract?

**Section 7702 - The Definition**

A. Historical Background: The historical definition of life insurance stems from Helvering v. LaGierse, 312 U.S. 531 (1941) which concluded that a life insurance policy would involve the shifting of mortality risk and risk distribution. The amount of risk necessary to constitute a life insurance policy was not an issue.

The tax benefits of life insurance -- tax deferred inside build up, FIFO accounting as to withdrawals were shared in by annuities. Thus in the mid-seventies it was possible for an individual to purchase a wide variety of investment vehicles and take a short term capital loss for any sales charge he might have paid for that investment when it was transferred to a custodial account for him at a life insurance company. At the life company where the earnings on that investment grew with no present tax implication, the investor would have investment control. He could withdraw up to his basic investment (as adjusted for the sales charge deduction) without tax.

A series of revenue rulings cut back these benefits starting with Revenue Ruling 77-85. The thinking involved with these rulings formed the genesis of TEFRA.

TEFRA by definition only provided stop gap legislation.

Most notably:

1. It reversed the accounting provisions of former law as it related to the withdrawal provisions of annuities but not of life insurance. Henceforth, for annuity withdrawals a LIFO convention applies meaning that ordinary income was first withdrawn until only the amounts contributed by the policyholder remained in the policy.
2. TEFRA's guideline provisions, which were applicable only to interest sensitive policies, defined what was required to constitute a life insurance policy for tax purposes. To this test, the sufficiency of risk undertaken by the insurer was critical.

The 1984 law at Section 7702 built on these TEFRA provision guidelines stating requirements which a policy must in fact meet in order to be treated as life insurance for federal income tax purposes. These were alternatively the cash value accumulation test which limits the cash surrender values to no more than the single premium for the contract for each policy duration and the guideline premium-cash value corridor guideline test.

Guideline Premium--Cash Value Corridor Test: The guideline premium test limits all premium payments for the policy to no more than the greater of the guideline single premium or the sum of the guideline level premiums from date of issue to date of evaluation. The cash value corridor requirement states that the death benefit payable in any given policy year must exceed the policy cash value by the percentages shown in the table, which are included with this material.

Under prior law, the IRS had authority to promulgate regulations to answer questions regarding the federal income tax treatment of withdrawals from Universal Life Insurance Policies. Authority is taken from the Treasury under tax reform 86.

Tax reform 86 provides specific provisions which apply to policy withdrawals which result in a reduction in benefits and occur during the first fifteen years of the policy. If policy withdrawal brings about a reduction in benefits and occurs within the first fifteen policy years that withdrawal will be subject to income taxation. Taxable income is limited to the amount by which the policy cash value exceeds aggregate premiums paid on the policy. However, Tax Reform 86 further specifies a ceiling on the amount of taxable income according to the policy year during which the taxable withdrawal is made and the applicable test used to satisfy the definition of life insurance after the withdrawal. Withdrawals during the first five policy years will have a greater proportion of the withdrawals taxable than would withdrawals
made during policy years six to fifteen. The taxable portion of the withdrawal during the first five policy years is based on the life insurance test being satisfied. If the cash value accumulation test is applicable, the maximum taxable income will be the amount by which the policy cash value before the withdrawal exceeds the net single premium of the policy after the benefit reduction. If the guideline premium test is being utilized the maximum taxable income on such a withdrawal will be the excess of the cash value before the withdrawal over the cash value corridor limit on the surviving policy.

Example:

William L. Haas: purchased a single premium universal life policy in 1986 for a premium of $30,000. In 1990 Bill withdraws $12,000 of the policies cash value in conjunction with a reduction in policy benefits. At the time of the withdrawal the cash value was $38,000. the net single premium for the surviving policy in 1990 is $33,000. He is taxed on the $5,000 of the withdrawal and the remaining $7,000 is considered to be a return of premium. This is less then the $8,000 gain which would be taxable income upon policy termination. The task for testing a life insurance policy and measuring the extent of withdrawals when the benefits have been reduced is complicated.

There are important questions that remain to be resolved. How will the IRS enforce these provisions? What will be the posture of life insurance companies which must report income on withdrawals?

I have found two diagrams authored by John J. Palmer, Senior Vice President of the Life Insurance Company of Virginia and contained in the 1984 ALI-ABA Conference on Life Insurance Products to be most helpful in understanding the Section 7702 tests, the transition rules, and effective dates. They are republished here.

The Section 7702 rules are sufficiently complex that many innocent unintended taxable transaction can be anticipated. Here the insurance companies through their field representatives cannot be relied upon to protect the policyholder from costly mistakes. How the company's home office responds to its withholding burdens will be critically important.
DIAGRAM OF BASIC SECTION 7702 TESTS

Is contract "life insurance" under state law?  

No → Fail

Yes → APPLY TEST AT TIME CONTRACT TERMS ARE SET

By terms of contract, is cash surrender value at any time greater than net single premium for current and future benefits?  

Yes → APPLY TESTS AT TIME CONTRACT VALUES CHANGE AND/OR PREMIUMS ARE RECEIVED

Compute Guideline Single Premiums
Compute Guideline Level Premiums
Accumulate Guideline Level Premiums over period contract has been in force
Select greater of GSP and sum of GLP's (This is Guideline Premium Limitation)

Does sum of premium paid exceed Guideline Premium Limitation?  

Yes → Fail
No → Does cash surrender value times Applicable Percentage exceed death benefit?  

Yes → Fail
No → Pass
DIAGRAM OF SECTION 7702 TRANSITION RULES
AND EFFECTIVE DATES

No

Was contract issued after December 31, 1984?

Yes

Does contract require at least 20 non-decreasing annual premiums?

No

Section 7702 Applies

Yes

Is contract issued under plan filed with a state before September 28, 1983?

No

Section 7702 Applies

Yes

SECTION 7702 APPLIES, BUT WITH 3\% (RATHER THAN 4\%) USED FOR CVA TEST

Is contract a flexible premium contract (issued before January 1, 1985)?

No

Neither

Yes

Section 101(f) Applies

Was contract issued after June 30, 1984 and before January 1, 1985?

No

Section 7702

Yes

Neither

Does contract have increasing death benefits and premium funding more rapid than 10-year funding?

No

Would contract (whether or not flexible premium) meet Sec. 101(f)?

Yes

Section 7702

No

Would contract meet CVA test with 3\% (rather than 4\%) and with maturity date 20 years from issue (rather than at age 95)?

Yes

Section 101(f) Applies

No

Does contract provide for premium adjustment to provide level death benefit (on at least a 3\% basis), or comparable death benefit adjustment (i.e., Irreplaceable Life form)?

Yes

Section 101(f) Applies

No

SECTION 7702 APPLIES
**Question 4:** How are loans from cash value life policies treated for tax purposes?

The rule for the deductibility of interest on loans made from cash value life insurance policies are set forth in IRC Section 264. This section denies deductibility of interest on loans:

1. To pay premiums on key man life insurance
2. On indebtedness incurred to purchase a single premium life policy.
3. To continue or carry a life policy pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the owner or otherwise except where:
   a. No part of four of the first seven annual premium payments is paid through indebtedness.
   b. Interest for the year does not exceed $100.
   c. Unforeseen substantial loss of income or unforeseen substantial rise in obligations.
   d. Incurred in connection with the trade of business

There is substantial doubt whether the Section 264 exceptions apply to Universal Life policies.

1. The universal life policy is a flexible premium product which does not require a set premium each year. Since it does not require a set premium a question arises as to how the insured may pay four of the first seven premiums.
2. Section 264B distinguishes between a premium and a deposit. Some commentators have felt that the premium paid to a universal policy was more in the form of a deposit than a premium and for that reason, interest on a loan on this type of policy would be denied deductibility.
3. Some commentators have suggested that if the universal policy is stripped of the flexibility of making different size premiums, but rather
premiums are kept even over the years, then the 264 interest deduction would apply. The same rationale as to the operability of 264 to universal policies is applicable to any flexible premium product.

Further regarding loans from insurance policies, one must be alert to other nuances, modifications and changes brought about by TRA 86.

1. A withdrawal during the first 15 years of a policy's existence which reduced policy benefits will subject the transaction to taxation to the extent provided in Section 7702 (E) (F) (G). The new law does not impose a similar result with respect to policy loans. Thus, for this reason, a withdrawal may often be preferred to a policy loan.

2. The Tax Reform Act is amended in the '86 code to phase out the deduction for personal interest paid. Personal interest paid is defined generally as interest paid other than trade or business interest, investment interest, or qualified residence interest. IRC Section 163 (H) (1). The deduction for personal interest will be allowed in part until 1991. Until then, the interest can be deducted to the extent set forth below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Deduction Percentage</th>
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<tbody>
<tr>
<td>1987</td>
<td>65%</td>
</tr>
<tr>
<td>1988</td>
<td>40%</td>
</tr>
<tr>
<td>1989</td>
<td>20%</td>
</tr>
<tr>
<td>1990</td>
<td>10%</td>
</tr>
</tbody>
</table>

It is possible that an insurance policy can be used as collateral for the purchase of an investment or that money paid for a policy may be obtained using the home as collateral. But in most such instances, the Section 264 rules regarding the financing of premiums present significant obstacles to the obtaining of a deduction for interest paid on the loan.

After the enactment of the tax reform act, interest paid or accrued on indebtedness incurred or continued in connection with the conduct of a trade or business remains deductible.

In the case of policy loans with respect to policies purchased after June 20, 1986 and owned by a business, a new loan ceiling has been introduced. An interest deduction will be allowed on up to $50,000 of the loan amount if (1) the policy is owned by the taxpayer, (2) there is a
trade or business carried on by the taxpayer, (3) the insured is either an officer, an employee, or a person financially interested in the business. The $50,000 amount per officer or employee or owner is to be determined on an aggregate basis for each person in all trade or businesses conducted by the taxpayer. Policies issued through June 20, 1986 are grandfathered and as such, there is no upper limit to interest deductions with respect to such loans on policies incurred in a trade or business. Because of the grandfathering rules that apply to policies issued on or before June 20, 1986, planning would dictate that businesses should retain existing policies, consider minimum depositing on up to $50,000 of loans and create a vanishing premium arrangement above that amount.

**Question 5:** What concerns regarding the new alternative minimum tax on businesses have been raised for corporate life insurance owners?

The tax reform act imposes an alternative minimum tax (AMT) on businesses that is payable to the extent that it exceeds the regular tax. Generally speaking, the AMT is imposed at a 20 percent rate on AMTI exceeding a $40,000 exemption amount. The exemption amount is phased out at the rate of .25 on each dollar of AMTI in the case of any corporation having AMT income exceeding $150,000. AMT income is the corporation's taxable income subject to certain adjustments plus items of a tax preference. For 1987 to 1989, AMT income also includes 50% of the corporation's "book income" not previously included in AMT income, subject to certain adjustments. For 1990 and thereafter, AMT income includes 75% of the corporation's earning and profits, subject to certain adjustments, not previously included in AMT income.

From 1987 through 1989, there will be an abnormal treatment for life insurance. Both premiums and policy loan interest will be deductible in determining net book income. However, any death benefits received by the corporation and any inside buildup on corporate owned policies will be included in income for purposes of determining book income. In effect, therefore, 50% of any policy loan interest will be included in income for purposes of determining book income. In effect, therefore, 50% of any policy loan interest will be deductible during an AMT year falling in 1987, 1988 and 1989. The restrictions pertaining to single premium contracts, the 4 out of 7 rule, etc. will not restrict this deduction.

**Question 6:** What protection to the claims of creditor is afforded by life policies to their cash values?
Statutes in most states provide at least some protection from the claims of creditors to life insurance cash values.

**Question 7: What is a Single Premium Life Policy?**

Generally speaking, a single premium life policy is structured so as to maximize cash values and the tax deferred savings aspect of the life insurance contract. Ordinarily, premiums are paid in the first or during the first four policy years. This means that even under the old rules, loans from such policies were not deductible. However, generally such a contract will have a "wash loan" provision and will credit interest to the cash value account on borrowed moneys at a rate similar to that which the insured is paying on his loan. Typically only a relatively small percentage, perhaps 10% (on some policies this rises to 50%) of the cash value can be accessed over the first few policy years unless a penalty is paid to the insurer. Typically, this penalty is a percentage of the amount borrowed, which reduces each year of the policy's life until, generally speaking, in the sixth to tenth year the penalty disappears.

**B: ANNUITIES**

**Question 1: What is an annuity?**

The annuity contract is not defined in the Internal Revenue Code. The term refers to a wide variety of plans which make periodic and systematic liquidation of a principal sum. Apparently, the growth in cash values which accumulates before distributions in an annuity contract is not presently taxed to its owner either under a Section 72, a constructive receipt or an unrealized capital gains theory.

An exception to this general rule regarding the non-taxability currently of the inside buildup of an annuity is new Section 72 (U) IRC which applies current income to tax buildups under a deferred annuity contract owned by a non natural person; e.g. a corporation. This new rule, makes exceptions for current taxation for any annuity contract which is acquired by the estate of a decedent by reason of the death of the decedent, held under a qualified plan, a tax sheltered annuity program, or an individual retirement plan, or is a qualified funding asset is an immediate annuity, or is purchased by an employer until the employee separates from service.

**Question 2: How are Annuity Withdrawals Taxed?**
Prior to TEFRA, the tax free cash value build up and LIFO accounting method for withdrawals applied to annuities. The IRS, starting with Revenue Ruling 77-85 had progressively moved to shut down what it conceived as the "annuity loophole". Still until TEFRA's enactment in August, 1982, the industry was aggressively marketing certain annuities, particularly the SPDA, emphasizing their benefits:

1. Interest earned on the annuity built tax free

2. Withdrawals would be viewed as return of capital until the policyholders contributions had been exhausted.

3. If there were penalties on withdrawal, they certainly weren't tax penalties. (The insurance companies usually placed contractural penalties in their policies to combat premature withdrawals).

4. The companies were guaranteeing some very high interest rates. If these were not paid, the policyholder could withdraw his money, often in circumstances where a policy fee would never be paid the company. Several companies which aggressively marketed during this period later met financial difficulty, e.g. Baldwin United and Charter.

Congress moved to close the loophole when it enacted TEFRA:

1. Grandfather provisions were granted for amounts invested in or credited to annuity contracts prior to August 13, 1982.

2. For contracts issued after August 13, 1982 cash withdrawals prior to the annuity starting date were calculated on a LIFO rather than a FIFO basis and were included in gross income to the extent the cash value in the contract exceeded the contributions made. The determination of gain was made immediately before any distribution was received and without regard to any surrender charge.

3. A five percent penalty tax was imposed on the amount of any distribution that was included in income to the extent that the amount was allocable to an investment made within ten years of the distribution. The penalty was not imposed if the distribution was made: (1) after the owner was 59 1/2, (2) when the owner was disabled, (3) at the time of the owner's death, (4) under
an annuity payment measured by the annuitant's life or which would carry over at least five years. No income was recognized to the recipient of an annuity on the death of the contract holder, the recipient was subject to income tax on the income accumulated in the contract when it was distributed.

Congress retained the LIFO accounting rules for cash withdrawals in the 1984 Act anad:

(1) Removed the ten year provision as an exception for imposition of the five percent penalty.

(2) Provided that language must be contained in the annuity that:

(A) If the owner dies before the annuity starting date, generally the entire interest must be distributed within five years of his death or, if within one year of his death, must be annuitized for some period not exceeding the beneficiary's life expectancy.

(B) If there is a spousal beneficiary upon the contract holder's death, the contract may be continued in the name of the spouse as owner.

(C) If the distribution has begun, it shall not be delayed by reason of the owner's death.

(3) An annuity contract issued in exchange for another would be considered a new contract subject to the new penalty and distribution at death rules.

The Grandfather provisions granted in TEFRA for amounts invested in or credited to investments in annuity contracts prior to August 13, 1982 continued in effect.

The DEFRA law was effective for contracts issued more than six months after the date of enactment, i.e. on or after January 18, 1985.

Tax Reform 86 provided that the five percent penalty tax for early withdrawals should be increased from five to ten percent.

The exception to this penalty rule for a series of substantially equal periodic payments was also changed.
Under TRA 86: 1) the payments must be at least annual 2) payments must be made either over the life or life expectancy of the taxpayer or the payments may be made over the joint lives or life expectancy of the taxpayer and his or her beneficiary. 3) the exception for a payout extending at least sixty months but less then the life or the life expectancy after the annuity starting date is eliminated.

Prior to age 59 1/2 the taxpayer changes to a lump sum payout then all amounts that would have been subject to the additional tax (plus appropriate interest) are brought into income in that year). 4) If a change is made to a non accepted method of payout after the individual reaches age 59 1/2 but before the passage of five years there is a similar recapture provison to that which appears above.

Immediate annuities and plan termination annuities purchased by employers and held until employees separation from service are added as exceptions to the additional tax.

The TRA 86 provisions are applicable to taxable years beginning after December 31, 1986.

Section 72D of former law provided an exclusion equal to the employees basis in a contributory annuity if that basis was recoverable within three years. This is repealed. The basis will now be excluded on a pro rata basis from day one of the payout period. Any unrecovered investment not excluded from gross income is deductable by the annuitant for his or her last taxable year or goes to a beneficiary or the annuitants estate. As they are in the nature of a refund of consideration paid, the deduction goes to the person entitled to such payments. Repeal of the three year basis recovery rule applies to individuals whose annuity starting date is after July 1, 1986 or to qualified plans where amounts are received after July 1, 1986. However, limitations of the exclusion ratio to unrecovered investments apply to individuals with annuity starting dates after December 31, 1986.

Question 3: How are loans on annuities treated for tax purposes?

Amount received as loans and the value of any part of an annuity contract pledged or assigned are treated as cash withdrawals to the extent applicable to the investment in annuity contracts after August 13, 1982.

C: INCOME TAX REFORM AND LIFE INSURANCE
Question 1: The marketability of life insurance as a Financial and tax planning vehicle has been enhanced with tax reform. Advertisements are now being presented to the public which make the following points:

1. Life companies have made agreements with prominent mutual fund managements. The mutual fund company will manage a clone of their widely known and successful fund which will be held in an allocated account by the insurance company. The insurance company may have several of these allocated accounts. The owner of a variable policy may, during the course of a year, "switch" the cash value element of his policy between several of these funds. Neither the income of these funds nor the switch from fund to fund will be a presently taxable event. These events are shielded from present taxation by being encapsulated in the insurance cash value. Naturally, growth in a non-variable interest sensitive policy will be similarly shielded.

2. Variable policies became so popular that one company sold over a billion dollars in premium last year.

3. The new "Kiddie" tax has made the single premium life policy a highly desirable substitute for custodianship otherwise established pursuant to the Uniform Gift to Minor Act. Some companies claim that by dropping $10,000 into a single premium policy, a parent or grandparent can make the child a millionaire. This assumes tax free compounding at present rates until the child reaches approximately age 70. Other companies suggest the single premium policy as an ideal accumulation vehicle for educational purposes.

4. Not surprisingly, the single premium variable policy is being favorably compared to mutual funds and tax free bond funds.

D: WEALTH TRANSFER

Insurance is generally viewed as uniquely suitable for certain donative transfers of wealth, as a medium for increasing the ultimate value transferred and for providing the liquidity to pay taxes required for an estate transfer. Conversely, the life insurance contract has been viewed as uniquely suitable for certain compensatory transfers. Witness the use of
split dollar insurance, group term insurance, insurance in funding non-qualified deferred compensation. Yet, a third use for the life contract is in the protection preservation and transmutation of capitalized values. Thus, we have insurance to fund buy or sell agreements which preserve and protects the value of a business and key man insurance which seeks to protect against the death of a key employee.

Certainly, insurance is a vehicle of transfer and, as such, its use must be planned with particular attention paid to state and federal transfer taxes.

E: TRANSFER TAX ISSUES

1. What Properties of life insurance contract make it particularly attractive to its transferee?

   Investment Characteristics: Interest sensitive, universal and variable contracts today compete actively with each other for business. The return on policy reserves is a vital aspect of this competition. If the policy's reserves are stated as cash, the current return on policies issued within the past ten years will probably compare favorably with bank accounts and U.S. Treasury offerings. Interest sensitive and universal policies also have long term annual guarantees below which the company cannot pay without breaching its contract. Companies offering variable contracts have usually made agreements with mutual fund sponsors to manage the policies reserves in allocated accounts. Typically, the policy holder can switch accounts four or five times a year without additional charge. Management companies participating in such reserve management include for example, Pioneer, Templeton, Van Eck, Phoenix, and Fidelity Reserve. Investments include cash, stocks, bonds, real estate, etc.

   If the policy is held to maturity usually considerable appreciation will be experienced.

   Income Tax Characteristics: The reserves accumulate without a current tax. There are favorable provisions as to loans and withdrawals. These have been reviewed in previous questions.

   Protection from Claims of Creditors: State Statutes will often provide a preferred status to life insurance contracts protecting them at least to a limited extent from the claims of creditors.

   Elusive Valuation: Various methods which provide
widely divergent valuations have been upheld in the valuation of life contracts. Knowledge in this area can be immensely valuable to your clients.

2. Why is an Insurance Policy A Most Attractive Transfer Vehicle for a Party Wishing to Make a Donation Transfer?

Income Tax: For the donor of property, one incentive is that future income earned on the gifted property will no longer be taxed to the donor. With a gift of life insurance this consideration is not present because the policy is not income producing property. That it's not income producing property makes it more appropriate for the donee. This may be particularly so when the donee is a child under the age of fourteen, whose unearned income could be taxed at his parents' highest marginal rates.

On policy maturity, proceeds will be subject to income tax only if there has been a "Transfer for Value" IRC § 101(a)(2). Ordinarily, this would not be part of a gratuitous transfer.

Gift Tax: There is limited advantage to the donor retaining a policy if presently held in his estate. Perhaps advantages would be the security of the cash value or the psychological life question from the attention potential donees might pay to a potentially valuable contract. Making the gift, removes the full amount of the death proceeds from the donor's estate when properly done. Yet, the value of the gift for gift tax purposes is the value of the policy at the date of the gift rather than the face amount of the policy. See Reg. 25.2512-6(a). For group policies see Rev. Rul. 76-490, 1976-2 CB 300.

The availability of the $10,000 annual exclusion under IRC 2503(b) depends on the nature of the transfer. Despite the inherently future nature of the right to receive death proceeds under a life insurance contract, the outright transfer of a policy to another is a gift of a present interest. Reg. 25.2503-3(a). This is true even if the policy has no cash value Rev. Rul. S5-408, 1955-1 CB 113. But, if the transfer is to a trustee, the availability of the annual exclusion will depend upon the terms of the trust, i.e. whether there is an identifiable trust beneficiary who has a "present" interest Reg. 25.2503(a). A gift of life insurance is said to have tremendous leverage because for a small gift or series of small gifts, (usually small enough to escape gift taxation under the annual exclusion rules for gift tax) a large benefit (the face
amount) can be transferred without inclusion for estate tax purposes.

**Generation Skipping Tax:** In the case of generation skipping transfers, the tax is levied on the amounts received by the transferees subject to a $1 million exemption which may be allocated by the transferor. All transfers of present interests under $10,000 per year per donee (including gifts of life insurance) would appear to escape the generation skipping tax S 2642(o)3.

**Estate Tax:** To effectively escape imposition of the estate tax in instances where gift of life insurance have been made, the donor must comply fully with IRC Sections 2035 and 2042 which will be reviewed in the next question.

**Control Issue:** Often a prospective donor will fail to make a gift for fear of losing control of assets which may prove necessary in his old age. A life insurance gift may appeal to this type minded individual where gifts of other assets would not. That's because a small amount gifted can result in a large amount received.

**Inflation:** Inflation can cause a small amount retained presently in the estate to grow to a substantial addition upon which estate tax is exacted. Even with inflation, a small amount gifted presently can have significant future impact due to the maximum potential for future appreciation found with life insurance.

**Timeliness:** A gift of life insurance can be particularly timely for its impact will be felt in the future, when the donor is no longer around to take care of his beneficiary.

3. In order to make a lifetime gift of life insurance effective for estate tax purposes, the donor must rid himself of all incidents of ownership in the policy. What is meant by transferring all incidents of ownership?

If the decedent possessed at his death any incidents of ownership in the policy exercisable either alone or in conjunction with any other person, then that policy's proceeds would be includable in the decedent's estate. Incidents of ownership are understood to include:

1. The right to change the beneficiary
2. The right to surrender or cancel the policy
3. The right to assign the policy
4. The right to revoke an assignment
5. The right to pledge the policy for a loan
6. The right to obtain a policy loan
7. The reversionary interest in the policy, but only if the value of the reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent.

Should a corporation of which decedent is the sole or controlling (owned stock possessing more than 50% of the total combined voting power of the corporation at the time of his death) stockholder at the time of his death possess incidents of ownership in the policy; these incidents will not be attributable to the decedent stockholder to the extent the policy proceeds are payable to the corporation or are used to pay a debt of the corporation. But, if such proceeds are not payable to or for the benefit of the corporation so as to be taken into consideration for estate inclusion when valuing the corporation, these benefits will be attributable to the decedent. But the power to surrender a group term policy shall not be attributable to any decedent through his stock ownership. Reg. S 20-2042-1(o).

Thus, when making a transfer of life insurance the transferor must take care to rid himself of all incidents of ownership in the policy in order that the entire face amount of the policy not be includable in his estate when he dies.

IRC Section 2035 entitled "Adjustments for Gifts Made Within Three Years of Death" has received much attention particularly as it refers to Life Insurance. Why?

The general rule of section 2035 was enacted in its present form in 1976 and reads:

(a) Inclusion of Gifts Made by Decedent: Except as provided in subsection (b) The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3 year period ending on the date of the decedent's death.

Exceptions to the general rule are entered at Subsection (b) and include bona fide sales and gifts
of a value less than the dollar amount requiring a gift tax return to be filed, but specifically excepting life insurance.

This exception to the general rule specifically as it applies to life insurance was enacted in 1978. Thus, we have the statutory law as it existed prior to ERTA and applied to decedent's dying before January 1, 1982.

Cases decided under this pre ERTA statutory authority developed a theory of "constructive ownership and transfer" in instances where the decedent insured never actually possessed any incidents of ownership in the policy but was the source of the first premium paid. Actually, the Service argued two areas of reasoning in advancing this "constructive ownership and transfer" includability approach:

1. "Beamed transfer" illustrated by such cases as Bel vs United States 452 F 2nd 683, 72-1 USTC paragraph 1218, 29 AFTR 2nd 72-1482 (CA-S, 1971) Cert. den. 1p. In this line of cases the service has argued that the insured was the prime motivator of the policy, paid the premium directly or indirectly but had the policy issued in the name of a third person.

2. "Agency Theory" The pure Agency Theory is represented by such cases as Estate of Kurihara 82 TC 51 (1984).

Despite significant judicial acceptance of the "constructive ownership - transfer" doctrine represented by such cases as Bel v U.S. 452 F 2nd 683 (5th Circ. 1971), Detroit Bank and Trust Co. 467 F 2nd 964 (6th Circuit 1971) Estate of Kurihara V Commissioner 82 TC 51 (1984, Estate of Baratta - Lorton V Commissioner TC Memo 1985 -72) notable exceptions were found in interpreting the pre-1982 law Estate of Tracy V Commissioner 82-2 USTC 13,499 (W.D. N.C. 1982), Hope V U.S. 691 F2d 786 (5th Circ. 1982) Estate of Clay V Commissioners 86 TC 1266 (1986) but see Estate of Saznaak V Commissioner TC Memo 1986-570.

Because of the significant threat that the constructive ownership transfer reasoning could be applied in a given case, practitioners took elaborate precautions to avoid its applications.

The 1981 amendment to S 2035 added new subsection
(d):

(d) Decedents Dying After 1981:

(1) In General. Except as otherwise provided in this subsection, Subsection (a) shall not apply to a decedent dying after December 31, 1981.

(2) Exceptions for Certain Transfers – Paragraph (1) of this subsection and paragraph (2) of subsection (b) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038, or 2042 or would have been included under any of such sections if such interest had been retained by the decedent.

Thus, paragraph (d)(1) states that the general rule of section 2035 shall not apply to decedents dying after December 31, 1981. But if a transfer made by decedent would have been includable in his gross estate under Sections 2036, 2037, 2038 or 2042, the general inclusionary rule of 2035(a) would apply to tax the full fair market value of the property at the time of death in decedent's gross estate.

The ERTA amendments appear clear. The statute refutes the basis for any argument of constructive ownership. Only where decedent held an incident of ownership which he transferred within three years of death can the general inclusionary provisions of 2035(a) apply.

Despite the clear language of the ERTA amendment to Section 2035, the IRS in Technical Advice Memorandum 85 09 005 continued to adhere to the holdings of Bel V United States 452 F2d 683, Detroit Bank and Trust Co. 467 F2d 964 and First National Bank of Oregon 357 F2d Supp. 1157. This case involved a 1983 decedent. The facts were that the insured's wife applied for and owned a policy on decedent's life which was paid for by loans from the decedent's wholly owned corporation. At no time did the insured have incidents of ownership in the policy. Yet, its proceeds were included in decedent's gross estate per TAM 85 09 005.

The estate in the TAM chose not to accept the IRS holding and litigated in the Tax Court. In a
case of first impression insofar that no other reported decision has considered the impact of Section 2035(d) on the three year rule. The Tax Court held for the estate. This was the same Tax Court that had held for the government in Bel V US and Kurihara.

In Leder Estate v. Commissioner 89 TC No. 20 (1987) The Tax Court held:

"We hold that the proceeds from the policy are not includable in the gross estate where the decedent did not possess at the time of his death, or at any time in the three years preceding his death, any of the incidents of ownership in the policy because (1) section 2042 is not applicable; (2) the section 2035(d)(2) exception to section 2035(d)(1) is not applicable because the conditions of section 2042 (or any of the other sections cited in section 2035(d)(2)) are never met; and (3) section 2035(d)(1) overrides section 2035(a)."

"The plain language of section 2035(d)(2) requires as a threshold issue that there be an interest in property under the terms of the sections it lists (e.g., sec. 2042). It requires that the decedent transfer an interest in property included in the gross estate or an interest that would have been included if the decedent had retained such an interest. The decedent must have had at some time such an interest in property, or else there is nothing for him to retain or transfer and section 2035(d)(2) cannot apply. If section 2035(d)(2) does not apply and no other exception to section 2035(d)(1) applies, section 2035(d)(1) acts to foreclose an consideration of includability in the gross estate under section 2035(a)."

The IRS can be anticipated to appeal the Leder case because of the high stakes it involves. Therefore, counsel would be best advised to follow planning procedures applicable to pre-Leder law until the area is fully settled.

What are the Principal Methods for Making a Donative Transfer of Life Insurance?

(a) Outright Gifts:

Will the donee be ready, willing and able to use the policy as intended by the donor or will the donor be content with a nonconforming use?
(1) A gift of life insurance to the donor's spouse, commonplace in the past, should now be carefully considered.

(a) Unlimited Marital Deduction removes the tax reason for such a transfer.

(b) Does transferor really wish to give up control.

(2) A gift to a minor child may leave the recipient legally incapable of exercising policy options without the appointment of a custodian.

(3) Contingent Ownership: In making any outright gift of a policy make provision for contingent ownership since the donee may survive the donor.

(4) If a policy is given to a third party intending another to be the beneficiary, safeguard against any possibility that upon the death of the policy donor an unintended taxable gift flowing from the policy's transferee to the beneficiary will be made an issue by the IRS.

(b) Custodial Gifts:

Generally more appropriate for gifts to minors. All state permit custodians under Uniform Gift to Minor Act statutes to hold insurance policies and some allow payment of premiums from UGMA funds. Such a custodianship meets 2503(c) requirements.

CAVEAT: An insured parent should not be named custodian. The policy would fall into the parents estate. Rev. Rul. 59-357, 1957-2 CB 212; Lober, 346 US 335 (1953).

(a) Section 2503(a) Trusts: Present interest exclusion for the life insurance gift allowed for 2503(a) Trust. If the minor beneficiary dies before 21, distribution must be to his estate or appointees. Remaindermen may be designated to take on default of appointment even though the minor is not legally capable of exercising the power.

During the trust's term the trustee must be empowered to expend both principal and income for the benefit of the minor. Thus, the trust should provide that the trustee may (but will not be required to) invest any funds in life premium but may at his discretion terminate any policies.
Sometimes seen as a negative to the choice of a 2503(a) trust, the right of the minor to compel total distribution at age 21 may be mitigated by providing the minor the right to compel such distribution but providing for the trust to continue if the minor fails to exercise right by affirmative action.

(d) Irrevocable trusts with Crummey Powers: By far the most popular method for making gifts of large amounts of life insurance is the irrevocable trust with Crummey powers and sometimes containing special powers of appointment.

What is the Irrevocable Life Insurance Trust and Why is it so Popular in Planning an Estate with Large Amounts of Life Insurance?

Receptacle for Life Insurance provides mechanism for relieving Donor's Estate of all incidents of ownership in policy.

Present Interest Gift

Mechanism for retrieving policy ownership to Donor in event of need

Professional Management of assets where policy retained in trust until maturity.

Discretionary Provisions for trustee provides flexibility to trust.

Former possibilities for income tax savings through defective trust provisions terminated by TRA 86.

Planning the disposition to the Irrevocable life insurance trust

Drafting to Avoid the Generation Skipping Transfer Tax

Measuring Life Insurance Needs Comparative Values

Some Traps

Question 1: What if any, advice do you provide a client who asks as to the appropriate amount of life insurance suitable to his needs?
This question refers simply to what risk protection an individual may desire from his insurance and does not involve the question of life insurance as an investment or savings vehicle. It is usually one of the first questions to be addressed by one financially planning for the individual. Please direct your attention to the chart which is headed. Note that it is divided into four quadrants. In the first quadrant in the upper left hand corner assemble the net worth of the individual. Critical to be asked at this juncture is what after tax income the client needs to maintain his present living standard or an acceptable living standard. We have found that in that need is a cornerstone. After stating what income the individual needs presently, he is then more readily able to come up with an appropriate number which will approximate the needs in the event of his death, (quadrant 2) his needs stated in present dollar terms that is critical in the instance where he might be disabled (quadrant 4), and for retirement (quadrant 3). Since we feel that the ultimate end for each individual is either going to be a premature death, a premature disability, or a retirement, this sheet should be able to assemble most of the information that in the final analysis will show what the individual will require for life insurance protection, disability protection and to promote his retirement needs. With the low cost of annual renewable term and knowing what is required for disability most professionals should be able to maintain a steady standard of living regardless of what end they meet. Thus, if premature death takes them, life insurance, primarily term, will maintain the financial affairs of the family. In the event of disability available cash flow should be augmented by the disability contract to an extent where financial circumstances are not reduced. The sufficiency of the retirement fund really is a question as to the extent of compensation an individual is able to obtain during life. The allocation between retirement and income is a subjective item for the client. Our job is to make certain that the allocation is tax and financially efficient. We make no distinction here between the funds set aside to finance the car, the education or the vacation, etc. This can be provided in a more detailed review.

Question 2: What guidelines may be given regarding competitive available prices for pure risk protection i.e. an annual renewable term policy for a standard risk?

Annual Renewable Term: Sometimes considered the most basic pure risk coverage. It combines pure risk protection with the ability to renew each year at a stated price up to a maximum age. This age will differ according to insurance company but typically
will be 65 or 70. At that time the coverage will cease. It is said to become very expensive at senior age levels. But check this out for yourself. You may be pleasantly surprised. The cost for term is stated as a cost per thousand for face amount at a given age. This cost will rise each year. The cost of policy is determined by reference to mortality table. This mortality table which is set out in exhibit shows from a population of one million persons the number which the actuary deems will die in a given year. Those dying are used as a numerator in a fraction with the total population at that age used as the denominator. The fraction is multiplied by the number of thousands required under the policy times a present value of one dollar. The net single premium for a policy first year is determined in this matter. Successive years are computed in a similar manner using as a denominator the number of lives that are available at the beginning of the policy. The rate will increase as do the number of deaths in the given policy year as shown by the mortality table. The value of one dollar applied in the fraction will be discounted according to how many years out the dollar is required. It is a discounted dollar which is used. This net single premium computation is important later in our discussion as it will reflect on the definition of life insurance.

Premiums for a competitive annual renewable term policy will fall below figures which appear in the mortality table. Many annual renewable term policies provide an opportunity to be reexamined for insurance every few years. If the applicant is found fit he may qualify for smaller premium charges than those for which he as insured may otherwise be subjected. By qualifying for these reentry premiums the cost of protection is kept quite reasonable. As with any insurance policy, the cost per thousand for annual renewable term can be significantly reduced when larger sized face amounts are purchased. For this reason it is often a worthwhile economy to combine your life insurance protection into a large policy rather than to have several small ones. Also it might be less expensive when considering additional coverage with the same company to combine that coverage with your existing coverage into a single policy. Further, note that at the end of the seventies, insurance premiums for annual renewable term drastically reduced. There has been some leveling if not a rise in these premiums in the last couple of years. Therefore it is wise to review the cost of any policies that were issued prior to 1975.

Question 3: What if any publications are available which objectively compare the pricing of cash value insurance products, term products, and single premium deferred annuities?

A simple calculation of insurance cost has never been devised. That is because the cost of life insurance varies depending upon what happens in the future.
1) The cost varies depending upon how long the policy is held.

2) The cost varies depending upon why the policy is terminated death or surrender.

3) There is variation depending upon future economic events.

4) There is variation depending upon the discretion of insurers management. The difference is how competitive that management wants to be.

5) The cost varies depending upon the basis for crediting interest on cash value policies; portfolio method, investment year method or a mix.

Model regulations available in several states address themselves to life insurance cost and require certain calculations showing the cost of a policy being sold at the first year, second year and typically the fifth, tenth, and twentieth year be delivered the the policy on sale. However, it is very wise in purchasing a significant amount of insurance to review a book such as Life Insurance a Consumer Guide Second Edition by Joseph M. Belth 1985 Indiana University. It is recommended by both life insurance critics and proponents.

Belth is a professor of life insurance at Indiana University and editor of the Insurance Forum a monthly publication. Professor Belth's book is unusual since it is a narrative rather then a statistical presentation. Professor Belth reviews the manner in which a company's actuarial department will cost its premium structure and points out that for a single product one company may charge a multiple of what another issuer will charge.

Not revealed in his book is the fact that Belth has uncovered the existence of a list of life insurance companies, possibly including reinsurance carriers, who are financially troubled. The list is apparently not a short one. It is maintained by the National Association of Insurance of Insurance Commissioners who to date have been unwilling to reveal the names or number of companies so listed. Non revelation may be a good thing as it avoids a potential run on the bank. But it provides little protection to the public which has been made aware only that a number of carriers are insufficient in their reserves. Other carriers are maintaining competitive rates for their insurance products throught the presence of deeply discounted "junk bonds" in their portfolios. Professor Belth therefore recommends that anyone contemplating the purchase of insurance do so with a company which has been rated "A+" by Best during each of the last ten policy years.

Best is one of two companies which provides statistical reports comparing the pricing of many companies primary products. Also,
Each year it publishes an analysis of an insurance company's financial condition. Unfortunately, this data is not overly revealing although it does provide Best's opinion through a system of marks, as to a company's relative strength and financial condition.

It is disturbing to note that two of the companies that were rated very highly by Best have been Baldwin United and Charter. These two companies had severe financial difficulties in the early 1980's.

The difficulties reached in costing a life insurance policy are clearly revealed in the problems that the SEC faced when variable life insurance was first introduced to the market. The SEC has dictated rules relevant to the loading of the investment portion of the contract. However, not included in the restrictions are the cost that would be applied to mortality risks, expenses, administrative support, and there can be substantial profit to the company hidden in these figures.

For a lawyer or consumer interested in variable life a careful reading should reveal the various forms of camouflages available to a company in loading its product. An excellent article entitled "Rebirth of Variable Life" may be found in the November, 1985 and January, 1986 issues of The Journal of The American Society of CLU. Also the subject has been well covered in the last four A.I.L.-ABA annual sessions entitled Life Insurance Company Products: Reviewing the article in the CLU Journal and Professor Belth's short book should give the consumer a good insight into comparative values of life insurance whatever the particular type.

**Question 4:** How does the annual renewable term rate of a competitive life policy for a standard risk compare with (a) PS-58 rates (b) Table One Rates?

The PS-58 Rates are used in computing the "economic benefit" of pure life protection that is taxable to the employee under qualified pension and profit sharing plans, split dollar plans and tax sheltered annuities. Alternatively, the cost of one year term as provided by the insured may be used. See Rev Rule 55-747, 1955-2CB228; Revenue Ruling 66-110, 1966-1CB12. Term insurance rules should be considerably lower then the PS-58 rates.

The cost of excess group term life insurance coverage for insurance provided after December 31, 1982 is provided by Table One. Regulation Section 1.79-3 (2) (P) (2). That cost is in keeping with competitive one year term coverage. The one year term coverage will be significantly less if large face amounts are involved. Both the PS-58 rates and the Table One rates are shown in the attached.

**Question 5:** How does an annual renewable rate compare with a five
The five year renewable rate provides a level annual rate for five years at which time the consumer could anticipate a step up in cost should he wish to continue his coverage. The annual renewable term rate would step up with each year that the insured wished coverage. For the five year period the annual renewable term would have a lower initial annual rate and a higher ultimate annual premium with total cost being somewhat higher than the five year renewable. The rate is calculated in the following manner.

**Question 6:** Could you review some particularly pertinent difficulties and situations which you have encountered with life insurance products, companies, and agents. How can this be avoided?