

FUNDAMENTALS OF LIFE INSURANCE – WHAT YOU NEED TO KNOW AND WHAT YOU THINK YOU KNOW

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SESSION I – A GUIDE TO LIFE INSURANCE PRODUCTS AND THEIR RISK CHARACTERISTICS*

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* The charts included in this presentation were provided by Gary L. Flotron and are from his materials entitled “Explaining the Unexplainable”.

I. **Basic Life Insurance Concepts**

A. The Definition of Life Insurance

1. Judicial – Helvering v. LeGierse: Risk distribution and risk shifting
2. Statutory – Section 7702: Actuarial tests

B. Moral Hazard

1. Defined
2. Insurers response

C. Adverse Selection

1. Defined
2. Insurers response

D. Insurable Interest

1. A state law issue
2. Wide variations in state law
3. Choice of law issues – Mayo v. Hartford Life
4. Trust issues – Chawla v. Transamerica

E. Investment Risk in Permanent Policies

1. The overlooked risk by most non-insurance professional advisors
2. In a world beyond whole life and term, there is a spectrum of investment risk
3. Buy and hold vs. Buy and manage

F. Credit Risk in All Policies

1. Term as well as permanent
2. State insurance funds
3. Carrier ratings
4. Diversification
5. Separate account policies

G. Constant Assumption vs. Reality

1. This is the real issue in relying on an initial policy illustration
2. And the argument for re-illustrating actual vs. illustrated performance

Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of “Permanent” Types of Insurance (Continued)

- What Causes This Policy Insolvency and Lapse?
- The Answer Is In the Very Delicate Relationship Between the Net Amount at Risk and Cash Value
- When Planned Assumed Funding Premiums Are Calculated With an Assumed Constant Rate of Return To Endow at Contract Maturity, Generally At or Near the End of the Mortality Table, As Long As Actual Rates of Return Remain At or Above the Assumed Rate of Return, Assuming No Change in Premiums, Cost of Insurance, Or Expenses, the Policy Will Endow or Mature

Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of “Permanent” Types of Insurance (Continued)

- However, If the Rate of Return Falls Below the Assumed Constant Rate of Return the Very Delicate Balance Between the Net Amount at Risk and Cash Value Is In Danger, and the Whole Thing Can Go Eschew Causing the Policy to Become Insolvent, Or Lapse, Unless Sufficient Additional Premiums Are Added
- Lower Rates of Return Than the Assumed Constant Rate of Return Causes a Decrease In Cash Value And an Increase In Net Amount at Risk

Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of “Permanent” Types of Insurance (Continued)

- This Results In an Increase In Cost of Insurance (COI) Because COI Is Determined By the Net Amount at Risk Multiplied By Mortality Rates For the Insured’s Attained Age In Any Particular Policy Year (Note Mortality Rates Increase Constantly Each Year and Exponentially At Older Ages)
- Cost of Insurance Is Deducted From the Cash Value, Now At an Increased Amount, Further Reducing the Cash Value

Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of “Permanent” Types of Insurance (Continued)

- With Volatile Rates of Return, And No Increase In The Funding Premium, The Result Can Be a “Death Spiral” Causing the Policy To Become Insolvent and Lapse
- The Policy Can Die Long Before the Insured
- The Following Three Graphs Illustrate the Interaction Between Rates of Return, Net Amount at Risk, Cost of Insurance and Mortality Rates

II. Term Life Insurance

1. Pure mortality – no investment element
2. Annual increased mortality risk
3. Conversion privilege

A. Individual Term

1. Types

- a. Annual renewable
- b. Guaranteed renewable
- c. Re-entry
- d. Level

2. Availability at older ages

Risk By Product Types - Term

Risk of Life Insurance Policies

Risk by Product Types – Term Insurance

What's Guaranteed

- Premium for a Period
- Death Benefit
- Renewability for a Period
- Conversion for a Period

What's Not Guaranteed - Risks

- Current Rates at End of Term Period
- Insurability at End of Maximum Term of Term Insurance
- Purchasing Power of Death Benefit

III. Permanent Insurance

A. General

1. Policy Pricing

- a. Mortality charge
- b. Expenses
- c. Investment return
- d. Policy persistence

2. Illustrations

- a. As sold
- b. Re-illustrated – annually?
- c. Understand their limitations – they reflect a constant return for umpteen years
- d. They are based on a number of disclosed and undisclosed assumptions, none of which may prove to be true
- e. The mesmerizing effect of illustrations on proposed insureds and their advisors

2. Common Policy Riders

- a. Return of premiums (ROP)
- b. Long-term care (LTC)
- c. Accelerated death benefit (ADB)

B. Permanent Policy Types

1. From no (or less) investment risk to more investment risk to total investment risk for the policy owner

1. Whole Life Insurance (WL)

a. Summary of Characteristics

1. Fixed premium – due for life
2. Fixed death benefit
3. Guaranteed cash value increases
4. Insurer bears all the investment risk, at a cost of lower returns
5. Cash values available to policy owner – by surrender or borrowing
6. Dividends paid on participating policies are not guaranteed
7. General account product
8. Whole life / term blend
9. Illustrations

Risk By Product Types – Whole Life

Risk of Life Insurance Policies

Risk by Product Types – Par Whole Life

What's Guaranteed

- Premium
- Premium Paying Period
- Cash Values (Minimum Guarantee)
- Death Benefit
- Policy Sustainability
- Premium Sufficiency

What's Not Guaranteed - Risks

- Dividends
- Purchasing Power
Depending on Dividend Amount and Option, Some Purchasing Power Protection can be afforded with Paid-Up Additional Insurance Dividend Option

Risk of Life Insurance Policies

Risk by Product Types – Blended Base Whole Life with Combination Paid-Up Additions and Decreasing Term Dividend Option and/or Paid-Up Additions Rider

What's Guaranteed

- Base Whole Life Premium
- Base Whole Life Premium Paying Period
- Base Whole Life Cash Values (Minimum Guarantee)
- Base Whole Life Death Benefit
- Base Whole Life Policy Sustainability
- Base Whole Life Premium Sufficiency
- Paid-Up Additions Rider – The Right to Purchase on a Continuous Ongoing Basis at a Fixed Dollar Premium Amount, Single Premium Paid-Up Whole Life Additions at the Insured's Attained Age for Each Policy Year
- Paid-Up Additions Rider Face Amount Purchased at Each Year's Attained Age
- Paid-Up Additions Rider Cash Values (Minimum Guarantee)
- Paid-Up Additions Rider Death Benefit, Policy Sustainability and Sufficiency

What's Not Guaranteed - Risks

- Dividends for Both Base Policy and Paid-Up Additions Rider
- Inadequate Dividends Failure to Cover Term Cost Requiring Term Premium Contributions, Which Probably Could Increase in Subsequent Years
- Purchasing Power Depends on Dividend Amount, Some Purchasing Power Protection Can be Afforded with the Paid-Up Additional Insurance Dividend Option After Paid-Up Additional Insurance Face Amount Additions Are Equal to the Initial Decreasing Term Face Amount

2. Universal Life / Flexible Premium Policies (UL)

a. Summary of Characteristics

1. Risk element – two choices
2. Accumulation element credited with interest
3. Investment risk shared between owner and insurer – interest floor
4. Illustrations
5. “Open architecture”
6. General account product
7. Premium flexibility – no fixed premiums; instead – planned or target “premiums”
8. Access to cash value by surrender, withdrawal or loan
9. Non-guaranteed mortality charges

Risk by Policy Types – Universal Life

Risk of Life Insurance Policies

Risk by Product Types – Universal Life

What's Guaranteed

- First Year Death Benefit and Minimum Required Amount of Premium
- Minimum Interest Crediting Rate
- Maximum Cost of Insurance
- Maximum Policy Expenses

What's Not Guaranteed - Risks

- Premium Sufficiency
- Policy Sustainability
- Current Interest Crediting Rates
- Current Costs of Insurance
- Current Policy Expenses
- Purchasing Power
 - Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

3. No Lapse Guarantee UL Policies (NLG)

a. Summary of Characteristics

1. Fixed premium due each year
2. Policy will stay in force whether or not there is cash value – permanent term
3. Trade-off is more guarantees in exchange for loss of premium flexibility and cash values
4. General lower crediting rates and higher costs of insurance
5. Effect of late premium payment on the guarantee
6. Traditional UL with durational guarantees as an alternative

Risk By Policy Types – No-Lapse Guarantee

Risk of Life Insurance Policies

Risk by Product Types – No Lapse Guarantee Universal Life

What's Guaranteed

- Premium amount if Paid Timely and Other Conditions
- Death Benefit Subject to Premium Conditions Above
- Policy Sustainability Subject to Premium Conditions Above
- Premium Sufficiency Subject to Premium Conditions Above

What's Not Guaranteed - Risks

- Carrier Solvency
- State Guarantee Fund Coverage
 - A.G. 38
- Purchasing Power

4. Equity Indexed Universal Life (EIUL)

a. Summary of Characteristics

1. Crediting rate is by reference to an equity index (like the S&P, excluding dividends), with a cap and a floor (zero return)
2. One chosen, the index is fixed
3. Policy owner gives up some upside for downside protection
4. General account product
5. Similar to – but different from variable
6. Illustrations
7. Complexity

Risk by Policy Types – Equity Indexed Life

Risk of Life Insurance Policies

Risk by Product Types – Indexed Universal Life

What's Guaranteed

- First Year Death Benefit and Minimum Required Amount of Premium
- Crediting Rate Formula
 - Based on Some Index Such as S&P 500 **Without** Dividend Component, with non-guaranteed Participation Rate and Caps; and Minimum Interest Crediting Rate (Typically 100 Basis Points or More Below UL Min. Rate but can be Zero)
- Maximum Cost of Insurance
- Maximum Policy Expenses

What's Not Guaranteed - Risks

- Premium Sufficiency
- Policy Sustainability
- Adequacy of Earnings
- Participation Rate
- Maximum Caps on Increase in Index
- Current Costs of Insurance
- Current Policy Expenses
- Purchasing Power
 - Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

5. Variable Universal Life (VUL)

a. Summary of Characteristics

1. All of the features of UL
2. Plus the ability of the owner to choose investments for the cash value among those offered under the policy
3. The policy is a security for SEC purposes
4. Separate account policy
5. Diversification and investor control rules
6. Investment risk is totally the policy owner's
7. Illustrations – may show returns up to 12% per year, but must also show 0%

Risk By Policy Types - Variable

Risk of Life Insurance Policies

Risk by Product Types – Variable Universal Life

What's Guaranteed

- First Year Death Benefit and Minimum Required Amount of Premium
- Minimum Interest Crediting Rate
- Maximum Cost of Insurance
- Maximum Policy Expenses

What's Not Guaranteed - Risks

- Premium Sufficiency
- Policy Sustainability
- Current Interest Crediting Rates
- Current Costs of Insurance
- Current Policy Expenses
- Purchasing Power
 - Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

6. Joint Life / Second-To-Die Policies (JL)

a. Summary of Characteristics

1. Proceeds payable at second death – usually husband and wife
2. Survivorship riders on single life policies as an alternative
3. Indicated only when survivor does not need death proceeds
4. May be issued in any policy type
5. Became popular after unlimited estate tax marital deduction

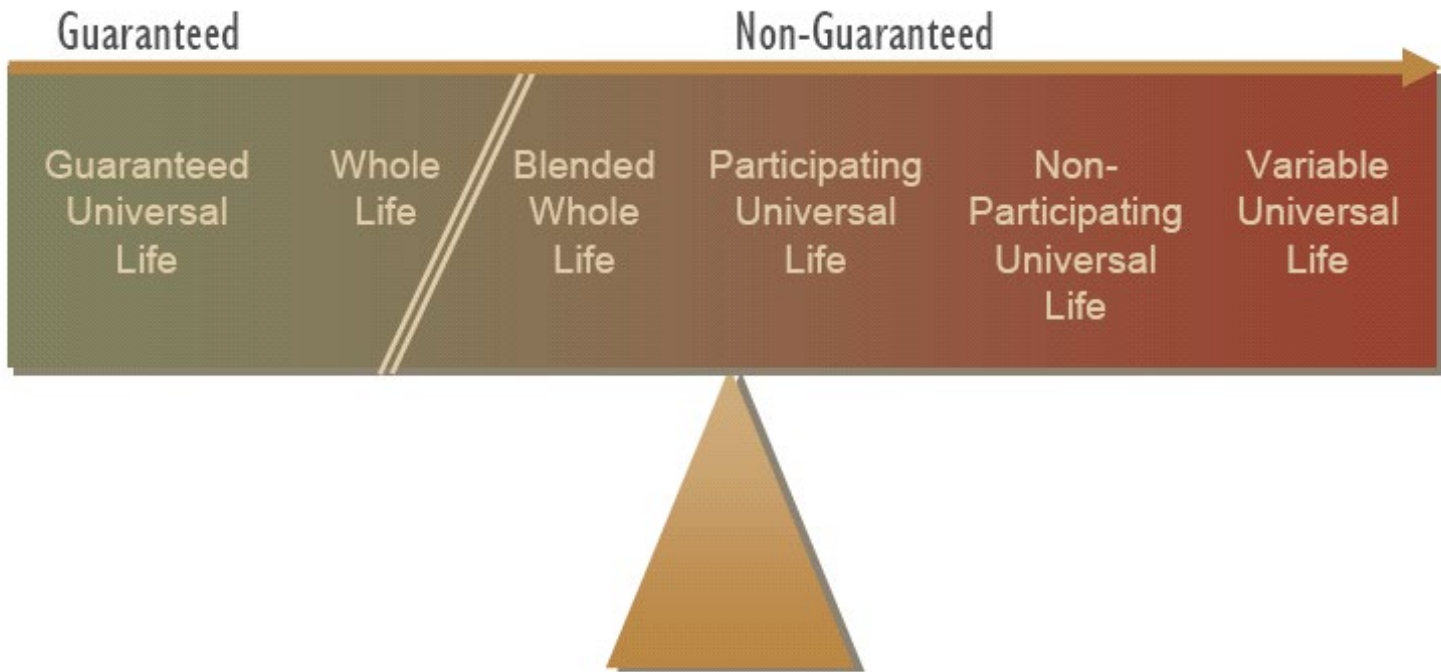
7. Single Premium Policies (SPWL)

- a. Modified Endowments – Section 7702A
 - 1. Death proceeds income tax free (assuming no TFV)
 - 2. Cash value grows income tax free
 - 3. Borrowing, withdrawing, or pledging the policy carries out income first, basis last
 - 4. 10% penalty unless the “taxpayer” is 59-1/2

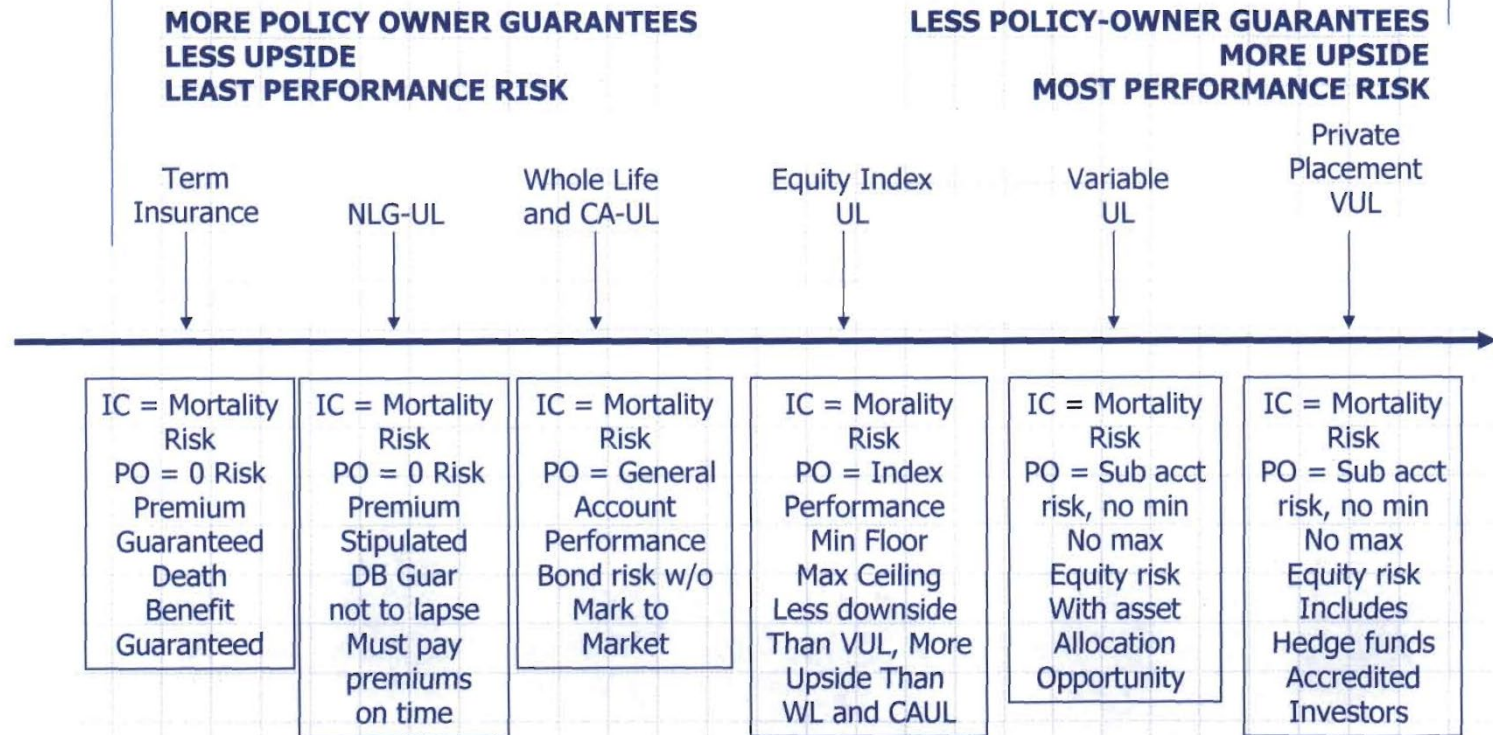
POLICY INVESTMENT RISK COMPARISONS

Policy Risk Spectrum

Risk



Design Criteria Risk Spectrum



Life Insurance Product—Risk Spectrum

<i>High Product Performance</i> <i>Risk Full Market Exposure</i> High Product Risk	<i>Hedged Product Performance</i> <i>Risk Limited Market Exposure</i>	<i>Reduced Product Performance</i> <i>Risk Carrier Portfolio Exposure</i>	<i>No Product Performance</i> <i>risk Guaranteed Results</i> Low Product Risk
<i>Variable Universal Life & Private Placement Life Insurance</i>	<i>Indexed Universal Life</i>	<i>Universal Life & Whole Life</i>	<i>Guaranteed Universal Life</i>
<ul style="list-style-type: none"> • Cash values are “invested” in a basket at mutual funds. • Cash values are not subject to claims of carriers’ creditors. • Policy owner takes investment risk, and performance is based on Investment performance. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums. 	<ul style="list-style-type: none"> • Cash values grow based on a specified market index’s return. • Cash values are not invested in the market; rather, a small portion buys call options on a specific index. • Carriers set cap and floor and offer guaranteed caps and floors. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums. 	<ul style="list-style-type: none"> • Cash values are invested by insurance carrier in bonds and mortgages. • Cash values are subject to claims of carriers’ creditors. • Crediting rates reflect “now money” rates • Carriers offer contractually guaranteed minimum crediting rates. 	<ul style="list-style-type: none"> • Premium amounts and durations are guaranteed and are not interest sensitive. • In essence, it is term to age 100, with carrier taking more performance risk. • Policies designed to have less cash value. • Non-correlated to other assets. • Marketplace is shrinking and/or re-pricing.

Session 2 – Wait—there’s more! Maybe you don’t know everything about income taxation of Life Insurance.

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DEATH PROCEEDS

- General Rule – Not Taxable
 - Viatical Settlements
 - Accelerated Payments

DEATH PROCEEDS

- Exceptions – Proceeds Taxable
 - Failure to Meet Definition of Life Insurance Contract
 - Transfer for Value
 - EOLI
 - Corporation/Employer Owner, Shareholders/Family Beneficiaries – Split Authority
 - Policies Owned by Qualified Plan – Partial Exclusion

DEATH PROCEEDS

TRANSFER FOR VALUE EXCEPTION

- General Rule – Sec. 101(a)(2) – Taxable
- Exception to Transfer for Value Taxation
 - Transfer to Insured or Insured's Grantor Trust (Rev. Rul. 2007-13)
 - Transfer to Insured's Partner or Partnership

DEATH PROCEEDS

TRANSFER FOR VALUE EXCEPTION

(CONTINUED)

- Transfer to Insured's Corporation
- Transferee's Basis All or Part Same as Transferor's
 - Sale by Insured to Insured's Grantor Trust
 - Sale by Insured's Grantor Trust to Insured's Grantor Trust
 - Sale of Policy Subject to Loan
 - Sale Between Spouses or Former Spouses
 - 1035 Exchange

DEATH PROCEEDS

TRANSFER FOR VALUE EXCEPTION

(CONTINUED)

- Life Settlement Sales
- Reportable Policy Sales
- Reporting Reportable Death Benefits and Policy Sales

DEATH PROCEEDS EOLI EXCEPTION

- General Rule – Employee Death Proceeds Over Basis Income – Sec. 101(j)
- Exceptions
 - Employee Status
 - Rank & File
 - Director or Highly Compensated
 - Not Paid to Employer
 - Payable to Employee Family or Designated Beneficiary
 - Finance Stock Redemption

DEATH PROCEEDS

EOLI EXCEPTION *(Continued)*

- Exception Requires Insured's Notice and Consent Before Policy Issue
 - Written Notice Employer Intends to Insure and Maximum Amount
 - Written Notice that Employer Will Be Beneficiary
 - Insured's Written Consent
 - Good Faith Inadvertent Failure Corrected Before Due Date of Employer's Tax Return
- Effective Date – August 17, 2006

TAXATION OF CASH VALUE

- Cash Value Build Up Tax-Free
- Distributions
 - Basis First Tax-Free
 - Excess Cash Value Second as Ordinary Income

TAXATION OF CASH VALUE

- What is Basis or Investment in Contract?
 - Premiums
 - Other Consideration
 - Tax-Free Policy Transfers
 - Reorganization
 - 1035 Exchange – Discussed Below
 - Between Spouses & Former Spouses
 - Sale by Insured to Insured's Grantor Trust or Vice Versa
 - Sale by Insured's Grantor Trust to Another Insured's Grantor Trust

TAXATION OF DIVIDENDS & WITHDRAWALS

- Dividends
 - Basis Reduced (Excess Over Basis Taxable)
 - Outright
 - Pay Loans and Interest
 - Pay Premiums on Policy Riders
 - Basis Not Reduced – Pay Premiums or Purchase Paid Up Additions
- Withdrawals – Non-MEC
 - Basis Reduced (Excess Over Basis Taxable)
 - 15 Year Exception – Income First up to Recapture Ceiling
- Loans – Non-MEC – No Basis Reduction

TAXATION AT SURRENDER, MATURITY & SALES

- Surrender or Maturity Proceeds
 - Basis Not Taxed
 - Cash Value over Basis – Ordinary Income
- Sales Proceeds
 - Basis Not Taxed
 - Cash Value Over Basis – Ordinary Income
 - Life Settlement Over Cash Value – Capital Gain

MODIFIED ENDOWMENT CONTRACT EXCEPTION

- Purpose
- Definition -- Section 7702A -- 7-Pay Test
- Material Change Restart
- June 21, 1988 Grandfathering

TAXATION OF MECs

- Dividends, Loans or Withdrawals From the Policy are Includable in Income
 - Where Cash Surrender Value Exceeds Investment in the Policy
 - Pledges or Assignments are Treated as Distributions
- 10% Penalty if the “taxpayer” is Under 59-1/2
- MEC Treatment isn’t Always a Problem
 - Death Benefit Treatment, Described Above

TAX FREE EXCHANGE – Sec. 1035

- Exchange for Life Insurance, Annuity, Qualified Long-Term Care Contracts (Reverse not True)
- Probably Need Same Owner (Grantor Trust)
- Same Insured (Second to Die Policy?)
- Inside Procedure Exchange
- Boot is Taxable (Policy Loans)

TAX FREE EXCHANGE – GRANDFATHERING

- Grandfathering Lost by Exchange
 - Definition of Life Insurance (12/31/1983)
 - MEC (6/21/1988)
 - Disallowance of Interest Deduction
 - UL 15 Year Withdraw Income Rule (12/31/1983)
 - Disallowance of ER General Interest Deduction (6/8/1997)
- Split Dollar Grandfathering (9/17/2003) – Uncertain
- Grandfathering Not Lost
 - EOLI Proceeds Income (8/17/2008)
 - Restructure by Insurance Company Rehabilitation

PREMIUMS INCLUDED IN INSURED'S INCOME

- NO – Personal Insurance
- YES – Executive Bonus Plan; Shareholder Owns
- NO – Key Person
- MAYBE – Employer Owns; Family Beneficiary

PREMIUMS INCLUDED IN INSURED'S INCOME *(Continued)*

- Split Dollar
 - YES – Economic Benefit Regime – COI
 - YES – Loan Regime – AFR
- YES – Group Term – Table 1 over \$50,000
- YES – Qualified Plan – Table 2001

PREMIUM DEDUCTION

- NO – Personally Owned
- NO – if employer Owner AND Beneficiary
- YES – Employer Pays – Employee Owns
- YES – Charitable Gift

INTEREST DEDUCTIONS POLICY LOANS

- NO – Personally Owned (After June 7, 1997)
- NO – Business Owned (After June 19, 1986)
 - Limited Key Person Exception
- Disallowed General Interest for Cash Value Allocated Thereto
 - 20% Owner, Officer, Director & Employee Exception

INTEREST DEDUCTIONS POLICY LOANS

- Additional Limitations If Otherwise Deductible
- Single premium Payment
- Systematic Borrowing
 - 4 out of 7 Exception
 - \$100 Exception
 - Unforeseen Events Exception
 - Trade or Business Exception

SESSION 3 – TRANSFER TAXATION OF LIFE INSURANCE

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Uses of Life Insurance

- 1. As an investment**
- 2. As asset protection**
- 3. To meet family needs and replace lost income**
- 4. To provide liquidity for estate taxes and other expenses at death**
- 5. To fund buy-outs at death**

Who Should Own the Policy?

- 1. The Insured**
- 2. The Insured's Spouse**
- 3. The Insured's children**
- 4. A Revocable Trust**
- 5. An LLC or Partnership**
- 6. An Irrevocable Trust**

Gifts of Insurance in General

- 1. Gifts of Policies**
- 2. Gifts of Cash**
- 3. Indirect Gifts**

Tax Aspects of Gifting

1. Gifting using Gift Tax Exemption
2. Gifting using the Annual Exclusion of Section 2503(b)(1).
 - a. Only Available for present interests.
 - b. Crummey v. Comm'r: 397 F.2d 81 (9th Cir. 1968).
 - c. The IRS looks for three things in the withdrawal power:
 - (1) Actual notice to the recipient.
 - (2) Reasonable time to exercise the power.
 - (3) Realistic ability to withdraw
 - d. Courts have not been so strict.
 - (1) Cristofani v. Comm'r, 97 T.C. 74 (1991)
 - (2) Turner v. Comm'r, T.C. Memo. 2011-29,
3. Deemed or Indirect Gift.

Crummey Power Example

Example

Bill is married to Jane

Bill and Jane have 3 adult children and 6 grandchildren

Bill wants his insurance trust to purchase a \$5 million policy on his life

John, Bill's insurance agent, has told Bill that premiums for this policy will be \$47,000 a year and the cash value of the policy, if premiums are paid will grow \$15,000 a year based on assumed growth rate of 33% (John really wants to sell this policy!)

Terms of Insurance Trust: Two Alternatives

Alternative A

Jane is Trustee and can distribute funds to herself for health, support and maintenance. Bill's children are also permissible beneficiaries and at Jane's death, receive the trust fund outright. If a child predeceases Bill/Jane, his or her children receive the deceased child's share.

Alternative B

Jane is Trustee and can distribute funds to herself for health, support and maintenance. Bill's descendants are also permissible beneficiaries. The trust terminates at the time required by the Rule Against Perpetuities.

FROM BILL'S PERSPECTIVE:

It is the same result for Bill under Alternative A or Alternative B:

1. Jane cannot make any gifts to this trust, so Bill cannot make his gift from a joint account or community property.
2. Bill wants to use his annual exclusion (\$14,000 in 2014).
3. Jane can gift split with Bill, so Bill has the ability to make gifts of \$28,000 per person to this trust, other than to Jane; however, Jane has told Bill she is making her own gifts, so gift splitting is not an option. Bill can make a gift to Jane as beneficiary, but it will be limited to the greater of \$5,000 or 5% of the Trust Fund, in order to avoid inclusion of any portion of the trust in Jane's estate.
4. Bill gifts \$47,000 to the Trust and will receive an annual exclusion for the entire gift, with properly drafted and administered Crummey powers.
 - a. Bill makes the check for \$47,000 payable to the trust which Jane deposits to the trust account.
 - b. Jane gives a notice to each of her three children: "your father made a gift to the trust and under the terms of the trust you have the right to withdraw \$14,000 for 30 days after you have received this notice. Please sign below to indicate your receipt of this notice."
 - (1) Alternative A: After 30 days, if you have not exercised your right of withdrawal, this right will lapse. (Client's like this alternative, no worries about a child exercising it later on.)
 - (2) Alternative B: After 30 days, if you have not exercised your right of withdrawal, then the amount over which you have a right of withdrawal will be reduced by that amount which is the greater of \$5,000 or 5% of the trust fund determined as of the date the thirty day period has ended.
 - (3) This is an issue for the beneficiaries, from Bill's perspective, he has received a \$14,000 annual exclusion for \$42,000 of his gift.

c. Bill receives an annual exclusion for the remaining \$5,000 of his gift by making the gift to Jane. As Trustee, Jane does not have to give notice to herself and under the terms of the trust, she has the right to withdraw for 30 days the greater of \$5,000 or 5% of the trust fund, which is \$5,000 (5% of \$47,000 is only \$2,350).

When this lapses, Jane has not made a gift to the trust because her withdrawal right falls within the “5 or 5” amount, so no issue with retained powers or including any portion of the trust fund in her estate.

d. Bill is done and happy.

FROM BENEFICIARY'S PERSPECTIVE:

There are very different results for the beneficiary between Alternative A or Alternative B, but both Alternatives result in inclusion in the child's estate of a portion of the Trust Fund if a child predeceases Bill:

Once Jane has given the notices to the children:

Alternative A: After 30 days, if you have not exercised your right of withdrawal, this right will lapse.

(a) When the lapse occurs, to the extent of the greater of \$5,000 or 5% of the trust fund, the lapse has no tax consequences (Section 2514(e)) but that leaves a \$9,000 gift each child has made to the trust as a result of allowing the withdrawal right to lapse.

(i) Jane's right was limited to the "5 or 5" amount, so there is no such issue for Jane.

(ii) If the children's rights were limited in the same manner, there would be no issue with respect to the children.

(b) To avoid a taxable gift of \$9,000 to the Trust by the child, we make it an "incomplete" gift by provided in the trust agreement that to the extent of any taxable gift, the child has a limited testamentary power to appoint such gifted property among the Settlor's issue. There is inclusion in the child's estate of all amounts over which the child has the power of appointment, but since the trust is being distributed to the child at the death of the survivor of Bill and Jane, there was estate inclusion in any case. But if the child predeceases Bill or Jane, then there is inclusion in the child's estate of the property over which the child had the limited testamentary power to appoint, even though the property remains in the trust (and not available to the child's estate to pay the estate tax).

(i) Consider whether you can add grandchildren as Crummey power holders, to reduce the amount over which the children have a right of withdrawal.

Alternative B: After 30 days, if you have not exercised your right of withdrawal, then the amount over which you have a right of withdrawal will be reduced by that amount which is the greater of \$5,000 or 5% of the trust fund determined as of the date the thirty day period has ended.

(a) Under this “hanging” provision, the child still has the right to withdraw \$9,000 after the 30 day period, so no taxable gift to the trust. But the child has a general power of appointment over the \$9,000 so inclusion in the child’s estate.

(b) The next year, Bill does the same thing, and now the child has the right to withdraw \$23,000 (\$14,000 present gift plus \$9,000 hanging from last year).

(i) the trust fund has grown by \$15,000. 5% of \$62,000 (\$47,000 gift plus \$15,000 policy value = value of trust) is still only \$3,100, so “5 or 5” amount is \$5,000.

(ii) \$5,000 of the withdrawal right lapses leaving the child with the right to withdraw \$18,000, which is making the problem worse.

(c) How to solve the problem

(i) Keep making gifts until value of trust (with policy growth) is high enough that the 5% amount is larger than \$5,000 and covers the hanging amount.

(ii) At Bill’s death, the “5 or 5” amount is 5% of \$5 million, or \$250,000; should cover entire “hanging” amount.

(iii) Consider adding grandchildren as Crummey power holders.

Generation-Skipping Transfer (“GST”) Tax

GST Tax Consequences That Can Arise with Insurance Trusts

- 1. Insurance Trusts with Multiple Beneficiaries.**
- 2. Allocation Rules**

The Estate Tax Consequences of Insurance

Estate Tax Inclusion of Insurance

- 1. If the policy is held in an irrevocable trust: gifts of the policy or cash can result retained interests under Sections 2036 and/or Section 2038.**
- 2. Under Section 2041(2), if the insured holds “incidents of ownership” over the policy, it will cause inclusion of the policy death benefit in the estate of the insured, regardless of the actual ownership of the policy.**
- 3. If the insured transfers the policy to the insurance trust within three years of death, there will be inclusion in the estate of the insured under Section 2035.**
- 4. If the death benefit is payable or paid, directly or indirectly to the estate of the insured, the death benefit will be includable in the estate of the insured under Section 2042(1).**

Valuation of Life Insurance Policies

1. The gift tax valuation of a policy is set out in Regulation Section 25. 2512-6(a).
2. The Regulations state that the fair market value of a policy for gift tax purposes is the cost of a “comparable” policy.
 - a. For a new policy, its gift tax value would be the premium paid.
 - b. For a single premium policy, its gift tax value is its replacement cost.
 - c. For a policy on which further premiums are due and which has been in force for some time (an undefined term), since replacement cost would be hard to determine, the regulations provide that its gift tax value can be approximated by the policy’s interpolated terminal reserve (“ITR”) plus any prepaid premiums.

Interpolated Terminal Reserve

- 1. The type of policy and the insured's health are not relevant considerations in the ITR determination.**
- 2. The ITR concept only realistically applies to traditional whole life policies**
- 3. Reserves that Set the ITR:**
- 4. Form 712**
- 5. The Regulations also provide that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula doesn't reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead)."**
- 6. Consider two alternative methods of valuation: the life settlement market and an independent appraisal.**

Paying the Premium in the Most Cost Effective Way

Loans

Economic Benefit