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Chapter 12

PLANNING OPPORTUNITIES WITH LIFE INSURANCE

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The preceding edition of this chapter was written by volunteers and staff and included material from the previous editions and supplements. This edition draws heavily from all of this previous work. The suggested forms in §§12.70 and 12.71 below appeared in the previous edition of this chapter and have not been reviewed or altered by Mr. Blase.

I. (§12.1) Introduction

Through the use of life insurance policies it is possible to transfer significant wealth from generation to generation that otherwise might be exposed to income taxation, gift taxation, estate taxation, or creditors' claims. The implications of the topic of "planning through the use of life insurance policies" are too extensive to be covered in this single chapter. What follows is a discussion of the principal issues involving life insurance with which the average practitioner should be familiar.

II. Overview of Policy Types and Taxation Issues

A. (§12.2) "Life Insurance" as Defined for Tax Purposes

Life insurance is defined by I.R.C. § 7702 as a "contract" that meets either a "cash value accumulation test" or the "guideline premium requirements" set forth in § 7702 and that "falls within the cash value corridor of subsection (d)." I.R.C. § 7702(a). The tests referred to in § 7702 are designed to see if the purported contract shifts risk among several insureds or whether it is a form of an investment that will provide a relatively ensured return. Because life insurance contracts are permitted to accumulate value "tax free" in the sense that the increase in value is not currently taxed for income tax purposes (at least until distributed), Congress wanted to make certain that this benefit was not conferred on an investment disguised as a life insurance contract. Thus, there must be a shifting of risk. *Helvering v. Le Gierse*, 312 U.S. 531 (1941). The "cash value accumulation test" and the "cash value corridor" test set forth in § 7702 are complex and require actuarial determinations. Unless counsel is an attorney for a life insurance company, counsel will probably not be called on in practice to determine whether a particular contract qualifies as a "life insurance contract." But as life insurance products become more esoteric and provide more complex features, if a particular contract raises concerns, counsel should ask to see a ruling or certification from the insurance company that verifies that a life insurance contract's status as such will be respected by the IRS (Internal Revenue

Service).

B. (§12.3) Types of Policies

Life insurance policies have various features and benefits that can differentiate one type of policy from another. Many policies have features that are combinations or permutations of other types of policies, and it is easy to become confused in this area. Each life insurance contract involves three "persons":

1. The "insured" (the person whose life is insured by the policy)

2. The "owner" of the policy, i.e., the person who has the right to cash in the policy, to designate the beneficiary, and to exercise any other rights under the policy contract

3. The "beneficiary" under the contract, i.e., the person or persons to whom the death proceeds will be paid upon the death of the insured

Many times, the owner and the insured are the same person. In addition, the policy usually permits the designation of a primary beneficiary or beneficiaries and contingent beneficiaries. Failing to consider the manner in which to name policy beneficiaries is a frequent mistake made by estate planners and their clients. Thus, regardless of the complexity of policies, the basics should not be ignored, even if the types of policies being considered by clients are various and complex. The classic types of policies that exist currently are discussed in §§12.4–12.11 below.

1. (§12.4) Term Life Insurance Policies

Term life insurance provides coverage for the life of an insured for a specified number of years, a "term." Once the term expires, coverage on the life of the insured ceases. Term life is supposedly "pure" life insurance because there is no investment feature of the policy. The premiums paid presumably compensate the insurer for taking the risk of insuring the life involved. The primary motivation for purchasing a term life insurance policy is the death benefit. The primary factor affecting the consumer's choice of policy amount or insurance company is usually cost. A decision to purchase term insurance usually means that the insurance need is only temporary.

Some term life insurance is labeled "annual renewable" term, which means that, for the owner of the policy to maintain a certain amount of insurance coverage, the owner must pay a premium, which increases each year. Some term contracts involve premiums that are level for, say, 10 years and then increase each 10 years thereafter for, perhaps, the 20-year term of the policy. Other term policies keep their premiums level but decrease the amount of coverage each year to correspond with the actuarial risk and costs associated with the policy.

Many term policies can be bought with the right to convert the policy into a whole life policy—i.e., to transform it to a whole life contract. *See* §12.5, *infra*. There is usually a time limit associated with this. The two classic types of options on conversion are:

1. Attained age
2. Original age

Attained-age conversions give the policyholder the right to convert to a whole life policy once a certain age has been attained. Original-age conversions permit a policyholder to convert the policy to a whole life policy as if it had been issued as a whole life policy on the original date of the term policy. The purpose of this second type of conversion is to permit a lower annual premium to be achieved, but a fairly large conversion premium is usually required to put the insurance company in the same position it would have been in had whole life premiums been paid from the beginning—i.e., from the original date of the policy.

Term insurance is usually purchased because:

- the need for the insurance exists only for a finite period of time (e.g., until children are out of college);
- the cash flow of the policyholder will not permit a whole life policy to be purchased; or
- the policyholder believes that the policyholder can do better with the "savings" component of what otherwise would be the whole life premium through other investments outside of a life insurance policy.

Term insurance is usually not a prudent purchase when the need for insurance coverage is permanent, when the policyholder is older, or when some savings or investment aspect is desired.

2. (§12.5) Whole Life or "Permanent" Insurance Policies

Whole life insurance is intended to provide coverage for the remaining lifetime of the insured. It combines two concepts: an "investment" in the policy as well as the life insurance risk factor. The typical whole life policy is designed so that level premiums are payable at regular intervals over the insured's life expectancy. A portion of these policy premiums compensates the insurance company for the risk of insuring the insured's life; the balance of the premium is "invested" and gradually accumulates a policy reserve amount that is actuarially determined to have a value equal to the face amount of the policy when the policy matures. The typical whole life insurance policy hypothesizes an insured's life expectancy as being either age 100 years or, in some cases, 95 years.

In effect, a whole life policy is the combination of an investment component plus a decreasing term life insurance policy. The sum of the policy's reserve plus the amount of the decreasing term coverage (insurance risk) is supposed to equal the face amount of the policy (the death benefit payable) throughout the policy's existence.

Some whole life policies are said to be "participating" in that the policyholder is entitled to a dividend (income) based on the financial performance of the insurance company. These "dividends" become important in determining a participating policy's true cost. If the insurance company has a history of gradually increasing its dividends, the policy will be "paid up" more quickly than a nonparticipating policy or a policy issued by a company that does not enjoy as high a rate of earnings that are credited to their policies or that does not "share" their earnings with their policyholders.

If an insured lives long enough, the reserve value of the policy—which is approximately equal to its "cash value"—rises so that the policyholder can either borrow money from the insurer up to the amount of the cash value or surrender the policy and receive the net cash surrender value of the contract. The net cash surrender value of a policy is the gross cash value reflected on the policy minus policy loans and surrender charges. Borrowing from a policy may create certain income tax problems; similarly, surrendering a policy for cash may give rise to taxable income if the investment in the contract is less than the amount of cash received. *See* §12.20, *infra*.

Some whole life policies permit a policyholder to "prepay" the amount of the cash, which otherwise would be paid in level premiums over the policy's period of existence. This "front loading" permits a more rapid accumulation of cash value, and if the policy's earnings produce a large enough reserve value, the increased earnings from this policy reserve may become sufficiently large enough to pay the premiums as they otherwise would come due. In effect, the policy becomes "paid up" because the insured is not required to pay any more sums to the insurance company to keep the policy in effect; the dividends do this for the insured instead.

The logical extreme of a "front loaded" whole life policy is a policy that is paid up with a single premium. As the name "single premium whole life" implies, a permanent life contract is purchased with a single large premium, paid only once, and thereafter the policy's dividends pay the costs of maintaining the policy in effect.

3. (§12.6) Variable Life Insurance Policies

A variable life insurance policy is a whole life policy that permits the owner of the policy to direct the manner in which the "savings" portion of the premium is invested. Typically, the insurer gives the investor/policyholder a choice of several mutual funds that may provide very different rates of return depending on prevailing interest rates and the management of these funds in the future. Although similar to a whole life policy, a variable life policy is different in several respects:

- The risk of the performance of the savings portion of the premium is shifted to the policyholder. There is no sharing of the investment or financial performance of the insurance company itself with the policyholder.

- The investment account of each policyholder is a separate, segregated account. Insurance companies are required to separate assets attributable to a variable life policy from the investment portfolio owned by the insurance company.

- It is important for counsel to note that, if the investment performance of the "savings" side to a variable life policy proves to be insufficient to produce the income or reserve amount required by the policy, the policyholder may be required to pay additional premiums to keep the insurance in effect, even though a comparable whole life policy—which was not a variable life policy—would have been "paid up" earlier. In other words, if the policyholder picks poor investments, the investment performance may not equal that of the same insurance company's whole life participating policy and may therefore not be adequate to ensure the desired level of insurance coverage.

4. (§12.7) Universal Life Insurance Policies

A universal life insurance policy, also referred to as "flexible premium adjustable life," permits the policyholder to pay an adjustable premium, within limits. The typical universal life policy also permits the policyholder to choose between two death benefit options:

1. A fixed death benefit similar to an ordinary life insurance contract

2. An amount equal to a pure insurance amount plus an amount equal to the policy's cash value at the time of the insured's death

A universal life policy permits the policyholder to withdraw cash or place more cash within the policy without the withdrawals or payments being treated as loans or repayments of loans.

Most universal life policies are "back end loaded," which means that the insurance company recovers some policy costs when the policy is surrendered or it pays off at death. This means that surrendering the policy in the early years of its existence may result in a substantial financial loss because commissions and costs are recovered by the insurer upon the policy's surrender.

Although beyond the scope of this chapter, universal life insurance policies are sometimes susceptible to being treated as modified endowment contracts. I.R.C. § 7702A.

5. (§12.8) Variable Universal Life Insurance Policies

A variable universal life insurance policy combines variable life and universal life concepts by permitting:

- adjustment of premium payments and timing of premiums;

- adjustment of death benefits;

- cash withdrawals;
- a choice of death benefit options; and
- a choice of investment vehicles.

6. (§12.9) Adjustable Life Insurance Policies

An adjustable life insurance policy purports to allow the policyholder to adjust the policy to meet changing needs and circumstances. The policy can assume characteristics typically associated with whole life policies or term policies and allow for low premiums or high premiums. This type of policy is similar to a universal life insurance policy, but it involves a good deal of paperwork on the part of the insurance company and tends to require the payment of a more expensive policy premium because of its increased administrative costs.

7. (§12.10) Survivorship Policies

Typically, survivorship policies are known as "second-to-die" or "last-to-die" policies. The death benefit is paid only when the last of two or more named insureds dies. Usually, these policies are permanent or whole life type insurance policies, although they can be term insurance policies as well.

The probability that two people of the same age will die during a particular period of time is about half of the probability that one person will die within the same period. Accordingly, it is usually possible to obtain a survivorship policy at a cost substantially less than what it would cost to insure just one life for the same period with the same age and mortality factors being applicable.

The primary usage of second-to-die policies with married couples is to help fund an estate tax liability on the death of the second spouse. Because a second-to-die policy can be purchased relatively cheaply and placed in an irrevocable life insurance trust or structured in such a way as to avoid the estate taxation of the policy proceeds, a relatively high after-tax benefit can be obtained for the premium dollars involved.

Another popular method of using survivorship life insurance policies is in a key-person situation when the loss of one person may not cause a business to suffer adverse consequences, but the loss of two or more key persons might be devastating to the company.

8. (§12.11) First-to-Die Life Insurance Policies

Another variation on the above theme is a "first-to-die" policy in which two or more persons are insureds under the policy, but the policy pays death benefits only upon the death of the first of the named insureds to die. Even though the insurance premium will probably be higher than the premium on only one insurance contract insuring just one life, the premium on a first-to-die policy should be substantially less than the combined premium on two separate contracts insuring these same two lives separately.

A traditional use of a first-to-die policy would be the funding of a cross-purchase agreement between business co-owners. Because only one surviving co-owner needs to purchase the business interest from the first co-owner to die, the need for policy proceeds expires after the death of the first co-owner.

Married spouses may also consider a first-to-die policy if they have young children who would require substantially more attention from a surviving spouse than would be possible based on their current employment, i.e., if both spouses work and the surviving spouse would be forced to curtail their employment for a period of time while their children are young.

C. (§12.12) Significant Options and Features With Respect to Life Insurance Policies

Life insurance "riders" or "endorsements" are optional provisions that are offered by an insurance company to take into account special circumstances. Life policies, by their nature, have certain basic features. But a policyholder may want to purchase additional "bells and whistles." Some of the more significant features, benefits, and riders that might be considered by the consumer or estate planner are discussed in §§12.13–12.15 below.

1. (§12.13) Typical "Riders"

A rider or endorsement to a policy provides an additional benefit, usually at an additional cost, that would not be offered as a part of the basic contract. The following are some of the more typical riders:

- "Guaranteed insurability" riders permit the policyholder to obtain more life insurance coverage at a later date without the requirement that the insured pass another physical examination or requalify for more insurance.

- "Accidental death" riders require additional death benefit proceeds to be paid if death occurs as a result of an accident (i.e., other than from natural causes).

- "Waiver of premium" riders require the insurance company to forgive or treat as though paid future premiums due on the policy if the policyholder becomes disabled. In a joint (survivorship) policy, a waiver of premium rider might permit the surviving spouse to cease making premium payments on a second-to-die policy.

- A "long-term care insurance" rider is typically added to a whole or universal life insurance policy with a defined death benefit. If the insured needs to use the long-term care portion of the policy, the insurance company deducts the amount used from the policy's death benefit.

2. (§12.14) Dividend Options

As described in §12.5 above, participating policies permit an insured to participate in the financial fortunes of the insurance company. Dividends can be paid to the insured in cash or can be applied to reduce subsequent life insurance premiums. If neither of these options is selected, the dividends can be added to the cash value of the policy to accumulate a greater cash value more rapidly. Alternatively, dividends can be used to purchase additional paid-up life insurance.

3. (§12.15) Policy Loans

Most whole life policies permit the policyholder to borrow an amount up to (but not in excess of) the cash value of the policy. If this occurs, the borrower is charged interest on the loan, but usually the policy establishes a rate of interest of around five percent or six percent on the unpaid balance. These loans are not required to be repaid before the insured dies, and if not repaid, the amount of the unpaid balance of the loan will reduce the death proceeds that otherwise would be paid. Policy loans can have a significant impact on performance, future dividends, and the proceeds paid to the insured's designated beneficiaries.

A variation on this theme is that some insurance companies automatically treat a loan as having been made if a premium is not made in a timely manner, i.e., they automatically "loan" to the policyholder the amount of the premium due from the policy's cash value, and thus avoid a lapse of the policy.

D. (§12.16) Income Taxation Concepts

The basic principles pertaining to the income taxation of life insurance policies discussed in §§12.17–12.27 below are among the more significant.

1. (§12.17) "Tax-Free" Build Up of Value Inside Policy

If a life insurance contract qualifies as such under I.R.C. § 7702, the increase in its cash surrender value will not be subject to current income taxation. Section 7702(g). If the contract is not a life insurance contract, the policyholder is required to report and pay tax on the excess of the cash value build up in the policy plus the value of the life insurance protection over the amount of premiums paid for that year.

One of the problems with a cash-free accumulation of value inside a life insurance policy is that for AMT (alternative minimum tax) purposes, a life insurance policy owned by a corporation is subject to the AMT, and the increase in the value of the policy is taken into account for this purpose. Treas. Reg. § 1.56(g)-1(c)(5)(v). The excess of any death proceeds collected by a corporation on a corporate-owned "key person" type life insurance policy will be included in the corporation's earnings and profits. Rev. Rul. 54-230, 1954-1 C.B. 114.

2. (§12.18) Dividends on Life Insurance Policies

Some participating policies pay cash "dividends"—i.e., a portion of the insurance company's earnings is distributed to the policyholder. The tax law treats these dividends as a return of the policyholder's premiums; thus, in effect, they become an income tax free distribution. I.R.C. § 72(e)(5). But once the policyholder has completely recovered the cost of the policy—i.e., has received enough in dividends to have paid back the premiums previously paid by the policyholder—the excess dividends distributed in cash to the policyholder are taxed as ordinary income. *Id.*; Treas. Reg. § 1.72-11(b)(1).

3. (§12.19) Cash Withdrawals From Policies

Some policies—such as universal and adjustable life insurance policies—permit periodic withdrawals of cash from the policy's cash value. The policyholder might receive this cash in exchange for a reduction in the amount of the death benefit afforded under the policy or because the policy permits this withdrawal in exchange for a reduction in some other benefit under the policy. The withdrawals are considered to be first a recovery of premiums paid before any income tax must be paid on the withdrawals. I.R.C. § 72(e)(5). But in the case of flexible premium policies issued after 1984, if the withdrawal occurs within the first 15 years of the policy's existence, and in the further event that the distribution reduces the policy's death benefit, the distribution is considered to be a partial distribution of both premium and income and may be partially taxable. I.R.C. § 7702(f)(7).

If the contract is not a life insurance contract but, instead, is treated as a MEC (modified endowment contract), distributions of cash will be treated as being distributions of income first, and only after all MEC income has been distributed will the distributions be treated as a recovery of principal. I.R.C. § 72(e)(10)(A).

4. (§12.20) Taxation Upon Surrender of Policy

If a policyholder completely surrenders a life insurance policy, the excess of the amount received over the policyholder's investment or tax basis in the policy is taxable as ordinary income. I.R.C. § 72(e)(5); Treas. Reg. § 1.72-11(d)(1).

The policyholder's investment or tax basis in a life insurance contract includes:

- premium paid;
- any dividends used to purchase paid-up additions;
- the economic benefit from the pure insurance portion (the "PS58 Cost"); and

- any economic benefit reportable under a split-dollar plan.

But this investment or tax basis would not include any additional premiums paid for accidental death benefits or for a waiver of premium rider, nor would it include interest paid on policy loans. Treas. Reg. § 1.72-16(b)(4); I.R.S. P.L.R. 8310027 (Dec. 3, 1982).

A policyholder may elect to take a policy's cash value in the form of an annuity. This would permit the policyholder to spread out any taxable gain by receiving installment payments that would be taxed ratably throughout the annuity period. I.R.C. § 72(h); Treas. Reg. § 1.72-12.

Many life insurance contracts eventually "mature"—i.e., terminate when the policyholder has lived long enough to have attained the stated maturity age set forth in the contract. While this may have been "unthinkable" in the past, if a life insurance policy now specifies a maturity age of 95 years, more and more people attain that age, and some people live many years beyond that age. When a policy "matures," the cash proceeds in the policy become immediately distributable (and taxable). Unfortunately, under the tax laws applicable to life insurance policies, the cash value of the policy in excess of the policyholder's investment in the policy immediately becomes taxable as ordinary income in the year of the policy's maturity. For this reason, some new contracts now are being issued that never "mature" until after the death of the insured.

5. (§12.21) Exclusion of Death Benefit Proceeds

Under I.R.C. § 101(a), gross income does not include amounts received under a life insurance contract paid by reason of the insured's death. This exclusion applies not only to the "pure insurance" portion of protection but also to any payments that are attributable to accumulated cash value in the policy before the policy's maturity. But the following rules apply:

- If the policy's proceeds are paid to a creditor of the deceased insured as the payment of a debt formerly owed by the decedent, the proceeds may lose their character as life insurance. This issue is usually resolved by an examination of how the debt would have been handled for income tax purposes upon payment. Treas. Reg. § 1.101-1(b)(4). If the payment received by the creditor is a return of capital, no income will be required to be reported. But if the loan was previously charged off (and deducted) as worthless, it might be ordinary income to the creditor.

- If the life insurance policy was owned by a qualified pension or profit-sharing plan, the proceeds of the policy paid at death are divided into two parts: the "pure insurance" portion and the "cash surrender value" portion. The pure insurance portion remains income tax free to the recipient; the cash value portion is treated as a part of the principal held in the retirement account and, thus, becomes ordinary income to the retirement plan beneficiary when the benefits are paid. I.R.C. §§ 72(m)(3)(C) and 403(a).

6. (§12.22) Transfer for Value Rule

One of the major traps for the unwary in the taxation of life insurance involves the "transfer for value" rule. This rule is found in I.R.C. § 101(a)(2) and provides:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by [the beneficiary under I.R.C. § 101(a)(1)] shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

This means that amounts that the parties might believe will be received income tax free may not, in fact, qualify for this favorable benefit if § 101(a)(2) is applicable.

Assume that Insured A owns a policy of life insurance on A's life and transfers the policy to Relative B in exchange for a payment by B to A of the cash value of the policy, which is $1,000 at the time. B then makes the premium payments on this policy until A dies. Everything received as a death benefit by B in excess of the $1,000 paid for the policy and the premiums paid by B after acquiring the policy will be treated as ordinary income to B under § 101(a)(2).

The term "transfer for a valuable consideration" is interpreted broadly and probably encompasses merely naming a person as a beneficiary under the policy in exchange for a valuable consideration. Treas. Reg. § 1.101-1(b)(4). Unfortunately, common sense does not apply in this area. There is no "guiding philosophy" that may be observed as a safe harbor—only the safe harbors specified in § 101(a)(2), which are listed below, may be used. Even if the transferee for value is a natural object of the insured's bounty, a familial relationship to the transferor is no defense to the application of this rule. *See*, *e.g.*, *Hacker v. Comm'r*, 36 B.T.A. 659 (1937); *Bean v. Comm'r*, 14 T.C.M. (CCH) 786 (1955); Lee Slavutin, *Tax Traps to Avoid in the Ownership and Transfer of Life Insurance Policies*, 74 TAXES 26 (Jan. 1996).

The transfer for value rule applies only if a valuable consideration is paid by the transferee for the policy or benefit. If the policy transfer is a gift, the rule will not apply. But caution should be exercised if there is an outstanding policy loan at the time of the transfer because a donee's assumption of the loan may be construed as "valuable consideration." Rev. Rul. 69-187, 1969-1 C.B. 45; Treas. Reg. § 1.1001-2(a). This will probably be the case if the amount of the loan exceeds the transferor's basis in the policy at the time of the gift.

Reciprocal promises might be construed as consideration in a transfer for value situation. *Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961), is instructive in this regard. In *Monroe*, the taxpayers and other stockholders of a closely held corporation agreed that they would buy all of the stock owned by Mrs. Gore upon her death. Two policies were purchased on Mrs. Gore's life with the corporation being named as the beneficiary. The ownership of the policies was assigned to Mrs. Gore and another stockholder in trust so that they could collect and pay over the proceeds (when Mrs. Gore died) as a part of the purchase price to be paid for the stock. The taxpayers agreed to pay part of the insurance premiums in consideration of Mrs. Gore's promise to assign the policies and sell the stock at a specified price. Mrs. Gore died, the trust received the proceeds, and the taxpayers used the proceeds to purchase the decedent's stock. The court held that the mutuality of promises under the circumstances of this case constituted an "integral part of the consideration for the assignment of the insurance policies," *id.* at 149, and held that the transfer for value rule made the policy proceeds taxable to the taxpayers for income tax purposes.

Five "safe harbor" exceptions exist that protect against the application of the transfer for value rule. The "safe harbors" are set forth in I.R.C. § 101(a)(2):

- The transfer for value rule does not apply if the transferee's basis in the policy or an interest in the policy is determined in whole or in part by reference to the transferor's basis.

- The transfer for value rule does not apply, regardless of whether consideration is paid, if the transfer of the policy is to the insured.

- A transfer of the policy to a partner of the insured is not considered a transfer for value.

- A transfer of the policy to a partnership in which the insured is a partner is not a transfer for value.

- A transfer of a policy to a corporation in which the insured is either an officer or a shareholder is not a transfer for value.

A corporation's buy/sell agreement can trigger the trap of the transfer for value rule. In I.R.S. P.L.R. 7734048 (May 26, 1977), the IRS was asked to consider two shareholders who each owned an insurance policy on their own respective lives—not on each other. After establishing a cross-purchase agreement, each shareholder transferred the policy insuring his life to the other shareholder so that, upon death, the insurance proceeds paid would permit the survivor to have available the funds required for the purchase of the stock owned by the first shareholder to die. The IRS ruled that a transfer for value had occurred, even though the policies, at the time of the transfer, had no value. Indeed, the IRS opined that this rule would have applied even if the policies had been term insurance policies.

In I.R.S. P.L.R. 7918022 (January 30, 1979), which involved a similar situation, the shareholders decided to circumvent the transfer for value rule by creating a partnership that purchased the policies for their fair market value and then used these policies to fund a buy/sell agreement. The IRS, in this second ruling, held that the transfer was to a protected party—i.e., a partnership in which the insureds were partners; thus, the proceeds could be received income tax free by the partnership because they qualified under one of the above "safe harbors."

A transfer for value issue might arise upon a termination of a buy/sell arrangement, which was the case in *In re Estate of Rath*, 608 F.2d 254 (6th Cir. 1979). In *Rath*, a corporation bought a life insurance policy on the life of its largest stockholder for stock cross-purchase agreement purposes, and when the corporation was sold and the buy/sell agreement became obsolete, the policy was sold to the stockholder's wife. The IRS claimed that there was a transfer from the corporation to the wife for valuable consideration and that the proceeds were taxable income to the wife upon the husband's death. The court ignored the fact that the insured could have acquired the policy himself from the corporation and then transferred it to his spouse, instead holding that the proceeds were taxable to the surviving spouse.

Another potential pitfall in the transfer for value area involves policies that are owned by a decedent on one or more persons who survive the decedent. In other words, what problems might exist if a decedent dies and part of the decedent's estate consists of life insurance policies on other persons? A personal representative might have the obligation to sell the policies for the best possible price. That sale might invoke the transfer for value rule and cause the purchasing person or entity to be taxed on the proceeds when and if collected unless the sale of the policies is to the insureds themselves. But the personal representative also might elect to sell the policies back to the insurance company, in effect, by cashing them in for their then-cash value.

Many other problems in the transfer for value area are beyond the scope of this chapter. *See*, *e.g.*, Lee Slavutin, *Tax Traps to Avoid in the Ownership and Transfer of Life Insurance Policies*, 74 TAXES 26.

7. (§12.23) Deductibility of Life Insurance Premiums

Generally, there is no deduction for a life insurance premium paid on a life insurance policy. Treas. Reg. § 1.262-1(b)(1). Instead, this payment is usually considered a nondeductible personal expense.

Even if a life insurance policy is owned for business purposes, I.R.C. § 264(a)(1) prohibits the deductibility of the premiums paid "if the taxpayer is directly or indirectly a beneficiary under the policy." But a premium payment may be deductible if the payment is in the nature of:

- employee compensation;
- a charitable contribution; or

- an alimony payment that meets certain other requirements.

8. (§12.24) Deductibility of Policy Loan Interest

Unless there is a payment or accrual of interest on a policy loan, there can be no deduction allowed for any interest payable with respect to a life insurance policy loan. I.R.C. § 163(a). Policyholders who are on the accrual method of accounting may deduct interest on a policy loan in the year in which it becomes due, even if payment of interest is not actually made that year, if the interest is otherwise deductible. But cash basis policyholders may deduct interest only in the year in which the interest is actually paid. *Id.*

There are relatively few situations in which an interest deduction will be allowed on a life insurance policy loan. Deductibility will depend primarily on how the loan proceeds are used. Temp. Treas. Reg. § 1.163-8T. Interest incurred on a loan that is made for use in a trade or business may be partially or wholly deductible based on the rules specified in I.R.C. § 264(f). But personal interest is not deductible; thus, a policy loan to fund a child's education probably would not be deductible. If the loan was obtained to make an investment in an asset that produces income, the interest might be deductible as investment interest to the extent that the taxpayer has investment income, again subject to the limits of § 264(f), which was enacted as of part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (§ 1084(c)), and effective for insurance contracts issued after June 8, 1997.

No deduction is allowed for interest payments on life insurance policy loans borrowed to pay premiums on the policy. Section 264(a)(3).

9. (§12.25) Taxation Upon Sale of Life Insurance Policy

If a policyholder sells a life insurance policy subject to the transfer for value rule, any gain realized as a result of the transaction will be taxed as ordinary gain and not as capital gain. Treas. Reg. § 1.61-2(d)(2)(ii). The gain is equal to the difference between the sales price (including any policy loan assumed by the transferee) and the net premium cost of the policy (total premiums paid minus tax-free dividends received). Rev. Rul. 70-38, 1970-1 C.B. 11. Losses on the sale of a life insurance policy typically are not recognizable and are nondeductible personal expenses. *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967 (3rd Cir. 1934); I.R.S. P.L.R. 9443020 (Oct. 28, 1994).

10. (§12.26) Alimony and Maintenance Issues

Under I.R.C. §§ 71 and 215, alimony is deductible by the payer and is taxable to the recipient. But under I.R.C. § 1041, no deduction is allowable when an asset is transferred from one spouse to another in the context of a dissolution of marriage. These transfers are treated in the same manner as gifts for income tax purposes. These same rules also apply to life insurance policies; thus, when a transferor spouse transfers a life insurance policy to the transferee spouse, the transferor spouse will not recognize income on the transfer. Temp. Treas. Reg. § 1.1041-1T, Q&A 7. This rule applies even if the value of the policy at the time of the transfer exceeds the transferor's basis. The transferee spouse will acquire the same basis in the policy as was formerly possessed by the transferor spouse.

Sometimes parties or a judge in a dissolution of marriage proceeding will require that a life insurance policy provide collateral security for the payment of a certain benefit after divorce. In this circumstance, there would not be a transfer of the policy; instead, for example, the insured spouse might be required to maintain a life insurance policy insuring the insured spouse's life and to irrevocably designate the former spouse as the primary beneficiary under it for a specified time period. Any death proceeds would be tax free to the recipient, but the premiums paid might be eligible for treatment as alimony. Temp. Treas. Reg. § 1.71-1T, Q&A 6.

Care should be taken in this context with respect to a change of beneficiaries after the required time period has lapsed.

11. (§12.27) I.R.C. § 1035—Tax-Free Exchanges of Life Insurance Policies

It is possible that the surrender of a life insurance policy will produce taxable income. *See* §12.25, *supra*. But I.R.C. § 1035 is available to mitigate this problem. The owner of a life insurance policy may want to exchange it for another policy because it is possible to obtain greater death benefits, to replace an existing policy with a policy offering the same protection with lower premiums, or for other reasons. Section 1035 allows one policy to be exchanged for another without income recognition and, thus, avoid the tax that otherwise would be imposed on the surrender of a policy. No gain or loss is recognized on the exchange of ordinary life insurance contracts, and the basis in the old policy is carried over to the new contract. *Id.* The new policy's basis becomes the old policy's basis plus any premiums paid after the exchange, reduced by any excludable dividends received after the exchange. *Id.*

Counsel should note that the exchange of a life insurance contract under § 1035 will not remove a "transfer for value" problem. Treas. Reg. § 1.101-1(b)(3)(iii). Furthermore, caution should be exercised if a policy being exchanged has a loan against it. Even if the requirements of § 1035 are met, a taxable gain equal to the "boot" received will occur, with the "boot" in this case being the amount by which the loan amount exceeds the policy's basis. I.R.S. P.L.R. 9141025 (Oct. 11, 1991).

Also, a § 1035 transaction with an insurance company must be clearly couched in terms of the exchange being one under § 1035. An absolute assignment of ownership of the old policy and an exchange agreement with the transferee—usually the insurance company—should be signed and make reference to § 1035 so that it is clear what is intended and being accomplished. I.R.S. G.C.M. 39,882 (Oct. 14, 1992).

Also, § 1035 requires that the insured in the old policy and the new policy be the same person. Thus, an exchange of one individual policy for a second-to-die or first-to-die contract with two insureds probably will not qualify under § 1035.

Should a term insurance policy be exchanged for a permanent insurance policy? Many term policies are convertible. But if the "conversion" is accomplished in the context of an exchange under § 1035, it might provide a significant opportunity to obtain a much higher tax basis in the new policy because the previously paid term premiums would count toward the new policy's basis. This opportunity should not be overlooked if this exchange, instead of a conversion, is possible.

E. (§12.28) Estate and Gift Taxation Issues

In addition to the complexities caused by the income tax laws, numerous provisions of the estate and gift tax laws pertain to life insurance policies.

1. (§12.29) Gifts of Life Insurance Policies and Proceeds

Gift taxes may arise when a gift of a life insurance policy occurs or when a payment of a premium on a policy is made by someone other than the owner of the policy. A potential gift tax situation may arise because of the assumption of a loan against an insurance policy in a gift context. Thus, the availability of the annual gift tax exclusion afforded by I.R.C. § 2503(b) is usually very important in this area.

a. (§12.30) Annual Gift Tax Exclusion

Under I.R.C. § 2503(b), an annual exclusion of up to $14,000 (in 2013) is permitted for gift tax computation purposes for gifts made by a donor to each donee during any particular calendar year. Section 2503(b)(2), enacted in 1997, prescribes that, in years after 1998, the exclusion is to increase (in increments of $1,000) based on the "cost-of-living adjustment" prescribed by I.R.C.

§ 1(f)(3).

The annual gift tax exclusion is available only for gifts of "present interests" in property. To be eligible for this treatment, the donee must have the immediate right to use and possess the property or to receive income from the property. Treas. Reg. § 25.2503-3(b). An outright gift of the ownership of a life insurance policy will be a gift of a present interest. Similarly, the payment of a premium on a policy that is owned by someone else will be a gift to the policy's owner of a present interest in property.

Outright gifts of life insurance policies to a trust or payments of cash to a trust that owns a life insurance policy for use by the trustee in paying policy premiums usually will *not* qualify for the annual gift tax exclusion, however, unless the trust's beneficiary receives a present interest in the gift. Treas. Reg. § 25.2503-2; *Comm'r v. Boeing*, 123 F.2d 86 (9th Cir. 1941); *see also* §12.44, *infra*.

b. (§12.31) Gifts of Proceeds

The policyholder has the right to designate the beneficiary of the policy. A policyholder's designation of a person as a beneficiary of the policy may be a gift to the beneficiary, at least technically, but as long as the policyholder retains the right to change the beneficiary, the gift remains incomplete for gift tax purposes. Treas. Reg. § 25.2511-2(b). When the insured dies and the beneficiary receives the proceeds, the power to revoke the gift has terminated, and the gift becomes complete. Thus, if the husband is the insured under a policy of insurance that is owned by the wife and the wife designates the wife's children as the beneficiaries under that policy, upon the husband's death, a gift by the wife to the children may be deemed to have occurred. In this event, the IRS may seek to tax the receipt of the proceeds by the children as a completed gift by the wife to the children. Rev. Rul. 73-207, 1973-1 C.B. 409; Rev.

Rul. 77-48, 1977-1 C.B. 292.

c. (§12.32) Valuation Problems

The value of a life insurance policy for gift tax purposes is its replacement cost—i.e., the amount that the insurance company would charge for a similar policy for another individual in the same state of health and of the same age as the insured on the date of the gift. Treas. Reg. § 25.2512-6(a). It is relatively easy to value a new policy because, if a new insurance policy is given away immediately after its purchase, the replacement cost will be equal to the first premium paid. Because a term insurance policy has no cash value, the gift tax value of a term insurance policy is typically equal to the unamortized premium for the current term as of the date of the gift. Treas. Reg. § 25.2512-6(a) (ex. 1). Most other life insurance policies are valued by reference to their "[i]nterpolated terminal reserve" and the unexpired portion of the most recent premium. Treas. Reg. § 25.2512-6(a) (ex. 4).

2. (§12.33) Estate Taxation Issues

Proceeds of a life insurance policy will be included in the decedent's estate for estate tax computation purposes if paid to the decedent's estate. I.R.C. § 2042. Insurance proceeds may also be includible in the gross estate of the decedent even if they are paid to someone other than the personal representative of the decedent's estate, if the payee must use the proceeds to pay debts, taxes, or other charges of the insured's estate. Treas. Reg. § 20.2042-1(b)(1).

a. (§12.34) Inclusion in Estate Because of "Incidents" of Ownership

The gross estate of a decedent also includes any insurance proceeds paid, regardless of to whom paid, if the insured possessed one or more "incidents of ownership" in the policy at the time of the insured's death. I.R.C. § 2042(2). The term "incidents of ownership" is broadly defined to include any economic interest in or benefit from the policy, such as possessing the power to:

- change the beneficiary;
- surrender or cancel the policy;
- assign the policy;
- pledge the policy for a loan;
- borrow against the cash surrender value of the policy; or
- prohibit the assignment or pledge of the policy.

Treas. Reg. § 20.2042-1(c); Rev. Rul. 75-70, 1975-1 C.B. 301. A fiduciary who possesses incidents of ownership over a policy on the fiduciary's own life, even though acting in a fiduciary capacity, is deemed to possess them individually. Section 20.2042-1(c)(4).

b. (§12.35) Inclusion Because of Transfer Within Three Years of Death and Techniques for Avoiding Inclusion

An insured's gift of the incidents of ownership in a life insurance policy, made within three years of the insured's death, will result in the inclusion of the value of the proceeds in the insured's gross estate under the rule of I.R.C. § 2035(b). This three-year rule does not apply to sales for full and adequate consideration. Section 2035(d).

Estate of Leder v. Commissioner, 89 T.C. 235 (1987), *affirmed*, 893 F.2d 237 (10th Cir. 1989), held that, if the insured never actually possessed any incidents of ownership, the insured's assistance in procuring the policy would not be sufficient to bring it within the insured's estate under the three-year rule. The Tax Court reaffirmed this rule in *Estate of Headrick v.*

Commissioner, 93 T.C. 171 (1989). *Headrick* involved a lawyer who created his own irrevocable life insurance trust and who named a bank as trustee. The bank agreed to apply for the insurance policy on the attorney's life and then paid the premiums from trust funds, which were furnished through gifts made by Mr. Headrick to the trustee. Mr. Headrick died within three years of the date of the trust's creation. In spite of IRS opposition, the Tax Court held that the proceeds of this policy were excludable from the insured's gross estate, citing *Leder*.

Techniques for avoiding the three-year rule include, in appropriate situations, having the insured/grantor transfer funds to an irrevocable grantor trust, followed by the purchase of the policy by the trustee, thereby avoiding both the three-year rule and the transfer for value rule. An alternative is to have the insured's spouse purchase the policy from the insured followed by a transfer of the policy to an irrevocable trust of which the spouse is not a beneficiary.

c. (§12.36) Inclusion of Policy in Estate Other Than That of Insured

Someone other than the insured may be the owner of a particular policy, and upon death, the title to that policy may be a part of the decedent's estate, even though the policy continues to insure the life of another person. Under I.R.C. § 2033, the value of this policy will be included in the estate, but the value of the policy will be determined as though a gift of a policy was made by the decedent as of the date of death. Treas. Reg. § 20.2031-8(a). *See* §12.32 above for the principles applicable to this valuation.

d. (§12.37) Estate Tax Marital Deduction

The estate tax marital deduction applies to transfers by a decedent to the decedent's spouse if the spouse does not receive a "terminable interest" in the property. I.R.C. § 2056(a); Treas. Reg. § 20.2056(a)-2. Proceeds paid to a surviving spouse should qualify for the estate tax marital deduction, but proceeds that are to benefit both the spouse and some other third person or persons may not. *Meyer v. United States*, 364 U.S. 410 (1960). The nuances of the marital deduction under § 2056 are beyond the scope of this chapter.

e. (§12.38) Split-Dollar Arrangement With Employer

A split-dollar arrangement is a form of cost-sharing agreement between two beneficiaries of a policy. Typically, this agreement exists between an employer and an employee. The employee asks the employer to acquire a policy on the employee's life. The cash value of the policy remains the property of the employer, and the employer has the right to recover from the death proceeds payable upon the employee's death an amount equal to the greater of the cash value or the total amount of premiums paid for the policy by the employer. The excess of the death proceeds over this amount is paid as the employee directs.

Under the typical arrangement, the employer would pay that part of the premiums that are equal to the increase in the policy's cash surrender value for each year, and the employee would pay only for the "pure insurance" portion of the premium, which is typically a negligible amount. In this manner, the insured employee can obtain life insurance coverage much more cheaply than might otherwise be possible.

The employee's power to change the beneficiary will be sufficient to cause the value of the proceeds to be included in the employee's gross estate under I.R.C. § 2042. But the employee's estate can exclude the amount that will go to the employer under this split-dollar arrangement for estate tax purposes. Furthermore, the employee, under this circumstance, might remove the proceeds of the policy from the employee's estate entirely by making an irrevocable assignment of the rights to make any beneficiary designation under the policy to some other third party (e.g., to an "irrevocable trust").

f. (§12.39) Split-Dollar Arrangement With Spouse

In I.R.S. P.L.R. 9636033 (Sept. 6, 1996), the IRS ruled on the transfer tax consequences of a "private" split-dollar insurance arrangement between a married couple. This ruling appears to bless a potentially advantageous split-dollar arrangement between spouses. In the private letter ruling, an irrevocable trust was created by the insured and the wife of the insured. The trust, in turn, acquired a policy of life insurance on the husband's life. The wife entered into a "split-dollar" agreement with the trust whereby, upon the termination of the agreement during the insured's lifetime, the wife would receive the entire cash value of the policy. If the agreement terminated upon the insured's death, the wife was to receive the greater of the amount of her premium contributions or the then-cash value of the policy.

The IRS was faced with three issues:

1. Whether the insured was deemed to have received anything of value as a result of the transaction and whether the insured was deemed to transfer anything to his wife as a result of the transaction

2. Whether the wife was deemed to have made a gift to the trust

3. Whether the value of the proceeds of the policy, when received by the trust, would be included in the husband's estate for federal estate tax

purposes

The IRS ruled that:

- the husband received nothing of value as a result of the agreement;

- the wife was not deemed to have made any gift because she would receive back an amount equal to the value of the premiums/cash value; and

- the value of the proceeds of the policy would not be included in the husband's estate for federal estate tax purposes.

This would not have been the result had the husband paid the premiums and received a security interest in return. Rev. Rul. 79-129, 1979-1 C.B. 306. If an insured holds a security interest in a policy on the insured's life, the proceeds are included in the insured's estate under I.R.C. § 2042.

This technique may have some possibilities in that significant insurance may be obtainable on a spouse's life without the corresponding gift tax problems that are described in §12.44 below. But counsel should note that the value of the benefit retained by the wife will be a part of her estate on her death.

See also the additional split-dollar plan discussion in §§12.63–12.67 below.

3. (§12.40) Generation-Skipping Problems

A discussion of the complexities of the GST (generation-skipping transfer) tax is beyond the scope of this chapter, though some planning considerations involving the GST tax are discussed in §12.45 below. Generally speaking, the GST tax is a tax on the value of property or any interest in property, including life insurance policies and proceeds, that is transferred by gift to a person in a generation that is at least two generations below that of the transferor. I.R.C. § 2613. The GST tax can be imposed if there is a gift directly to a "skip person," who is an individual in a generation at least two or more below the transferor—e.g., a gift by a grandfather to a grandchild. A gift of a life insurance policy to an insured's grandchild or to a trust solely for that grandchild and that grandchild's descendants would constitute a "direct skip," and the tax would be imposed at the time of the transfer on the policy's "interpolated terminal reserve," the taxable amount in a direct-skip situation. I.R.C. § 2642(a).

The two major exemptions from the GST tax are:

1. the $5.25 million aggregate GST tax exemption (amount for the 2013 tax year) provided by I.R.C. § 2632(a)(1); and

2. the fact that a $14,000 annual gift tax exclusion (amount for the 2013 tax year) for gift tax purposes also may apply to certain GST tax situations.

Section 2642(c)(3). An outright direct-skip gift that is "nontaxable" for *gift tax* purposes under I.R.C. § 2503(b) or (e) will also be nontaxable for GST tax purposes. Section 2642(c). But the annual exclusion is available to reduce or eliminate the GST tax only in the case of a direct-skip gift. A transfer in trust for the benefit of both nonskip persons and skip persons will *not* qualify for the annual exclusion for GST tax purposes, and therefore the transferor must allocate a portion of the transferor's GST exemption to the trust to keep the trust exempt from GST tax. Section 2642. Jonathan Blattmachr & Georgiana J. Slade, *Skipping Generations With Irrevocable Life Insurance Trusts*, 132 TR. & EST. 10 (Apr. 1993).

4. (§12.41) Economic Growth and Tax Relief Reconciliation Act of 2001

The EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001), Pub. L. No. 107-16, 115 Stat. 38, had a big impact on the estate, gift, and GST tax arenas by reducing and phasing out the estate and GST taxes. The "sunsetting" of these provisions took place in 2010 and resulted in a one-year tax repeal. EGTRRA § 901 (*see* I.R.C. § 1 Note). The lapsed provision was reinstated in 2011 with a maximum tax rate of 35% and a $5 million exemption.

The exemption amount was eventually increased to $5.25 million in 2013, including future annual adjustments for inflation. I.R.C. § 2010(c). These generous amounts may reduce or eliminate estate tax planning problems with life insurance for smaller estates, especially in the areas of liquidity and planning for payment of estate taxes. But life insurance will continue to play a role in more traditional areas of estate planning, such as:

- premature death;
- providing education;
- funding buy/sell agreements for family-owned businesses; and
- other needs, including estate equalization among family members after the insured's death.

III. Planning Opportunities

A. (§12.42) Personal Life Insurance Trusts

Life insurance trusts of various types and descriptions are basic tools in estate planning. These trusts may be revocable or irrevocable, and they may have, among many features, a view toward avoiding or eliminating estate taxes on life insurance policy proceeds.

1. (§12.43) Revocable Trusts

A revocable trust offers a maximum of flexibility while at the same time achieving numerous goals. Skilled management can be obtained, probate avoidance (if that is a goal) can be obtained, and the power to amend or revoke the trust permits changes in time and circumstances to be taken into account at the whim and discretion of the grantor. But the typical revocable trust will not remove a life insurance policy or proceeds from the insured's gross estate if the grantor/insured had any of the incidents of ownership of the policy before death. Under I.R.C. § 2038, property of a revocable trust will be included in the grantor's estate, including the value of any insurance proceeds paid on policies owned or controlled by the trustee of that trust.

2. (§12.44) Irrevocable Life Insurance Trusts

The major advantage of an irrevocable life insurance trust is that the trust can remove the insurance policy's death proceeds from the estate of both the insured and the spouse of the insured. Nevertheless, if carefully drafted, the trust instrument can make the proceeds available to meet the needs of the surviving spouse and the needs of the insured's estate.

One of the disadvantages of an irrevocable trust is that it cannot be changed. Another disadvantage is that it is somewhat expensive to prepare and operate on an annual basis. Because an irrevocable trust is a separate taxpayer, it must have a separate taxpayer identification number, and it is subject to annual trust income tax return filing requirements.

A significant difficulty with an irrevocable life insurance trust is that care must be taken to preserve its eligibility for the annual gift tax exclusion under I.R.C. § 2503(b). A gift to an irrevocable trust is a nonqualifying gift of a *future* interest in the absence of a special provision in the trust creating a present interest in one or more beneficiaries. This "special provision" came into the law under *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), and, hence, has become known as a "Crummey power." Henry J. Lischer, Jr., *Crummey Estate Planning: Successful Techniques for Gifts* *to Minors and Insurance Trusts*, 16 U. MIAMI INST. ON EST. PLAN. ch. 18 (1982).

A Crummey (withdrawal) power creates a present interest in a beneficiary despite the fact that it may be available only for a short period of time. This type of demand power permits a beneficiary to insist on a withdrawal of funds from a trust shortly after a donor deposits the funds with the trustee.

The Crummey power can be construed—and is construed by the IRS (Internal Revenue Service)—as the power possessed by a beneficiary to appoint trust funds to the beneficiary. The lapse of the Crummey demand power may be a taxable gift by the beneficiary of the Crummey power to the other persons who have interests in the trust and whose interests, therefore, are enlarged by an amount equal to the amount of the value of the property that could have been appointed but for the lapse of the Crummey power. Any such gift by the holder of a Crummey power that lapses would be a gift of a future interest; thus, the beneficiary of a Crummey power who permits the power to lapse would be required to file annual gift tax returns and use part of the beneficiary's applicable credit amount, if available, or to pay gift tax as a result of this lapse, unless the instrument that creates this power is properly drafted by the attorney. *See* William S. Huff, *The "Five and Five" Power and Lapsed Powers of Withdrawal*, 15 U. MIAMI INST. ON EST. PLAN. ch. 87 (1981); William Natbony, *The Crummey Trust and "Five and Five" Powers After ERTA*, 60 TAXES 497 (1982).

The most common way to eliminate a Crummey beneficiary's gift tax problem is by limiting each demand power to a noncumulative annual right to withdraw the greater of $5,000 or five percent of the value of the trust funds. The lapse or release of a general power of appointment is not a taxable gift except to the extent that it exceeds the greater of $5,000 or five percent of the trust funds from which the gift could have been satisfied. I.R.C. § 2514(e); Treas. Reg. § 25.2514-3(c)(4).

One of the modern techniques of avoiding gift tax problems caused by the lapse of a Crummey demand power in excess of the five percent or $5,000 limit is the so-called "hanging Crummey power." The "hanging Crummey power" is a drafting technique that provides that the Crummey power of appointment lapses in stages—i.e., it lapses each year to the greatest extent possible under the $5,000 or five percent limit, with any excess of the value of the current gift over this limit remaining subject to an ongoing withdrawal right, with such ongoing withdrawal right to lapse only to the extent of the greater of $5,000 or five percent of the trust's funds each year thereafter.

The following example may make this easier to understand. Assume that the father creates an irrevocable life insurance trust and the trust document gives each of his two children a hanging Crummey withdrawal power. The father contributes $40,000 annually to the trust, and the trustee of the trust uses this contribution to purchase life insurance on the father's life. The father and mother elect to split the gifts for gift tax purposes—i.e., to treat the $40,000 contribution as though made one-half by each parent, or $10,000 by each parent to each child, which, in turn, can be covered by the parent's annual gift tax exclusion. In year one, each of the children would have the right to demand the immediate distribution of $20,000, but if a child failed to exercise this right of withdrawal, in accordance with the trust agreement, after 30 days each demand right would lapse as to the greater of $5,000 or five percent of the value of trust assets. The remaining $15,000 in this example "hangs on" and remains subject to the child's ongoing demand rights in later years until the value of the trust has increased enough so that there are sufficient funds with which to satisfy this "hanging right"—or it lapses at the rate of $5,000 per year, whichever first occurs. In this manner, the children avoid being considered as having made a gift of a future interest in property by failing to exercise a Crummey power of withdrawal.
For an example of an irrevocable life insurance trust that employs a hanging Crummey power, see §12.70 below. An example of a typical estate planning letter to clients that

might be necessary to give advice as to what insurance policies should be considered is in §12.71 below.

Note: If the beneficiary possesses a hanging withdrawal power over more than one trust, the Crummey withdrawal powers in each trust need to be carefully coordinated in order to avoid a taxable gift by the beneficiary under I.R.C. § 2514.

3. (§12.45) Generation-Skipping Planning

A transferor's GST (generation-skipping transfer) tax exemption can be allocated to a life insurance trust either during the transferor's lifetime or at death. Ideally, this exemption is applied against property that will grow in value so that it protects not only the property against which it is applied upon its transfer but also the appreciation in value of that property thereafter. In other words, if $1 million of exemption is applied against property worth $1 million when the exemption is allocated, this allocation should be used to insulate the transfer from the GST tax even if the property grows to be worth much more than $1 million before the actual generation skip occurs. Using the exemption to shelter life insurance premiums can have this effect.

There is a somewhat complex problem involving the ETIP (estate tax inclusion period) rule, which is found in I.R.C. § 2642(f)(3). An ETIP exists when the value of the transferred property would be included in the transferor's gross estate if the transferor died immediately after the transfer. But transfers included by virtue of I.R.C. § 2035 are *not* included for this purpose.

Caution should be taken to make certain that a transferor's spouse does not have a sufficient interest in a transferred asset to cause its value to be included in the spouse's gross estate if the spouse were to die immediately after the date of the transfer. Treas. Reg. § 26.2632-1(c)(2)(i).

A split-dollar arrangement may increase the amount that can be allocated to a generation-skipping trust by reducing the amount deemed applicable to the insurance benefit. It is possible that the gift tax value of a policy held in a generation-skipping life insurance trust that involves a split-dollar arrangement can be reduced to the lower of:

- the economic benefit from the pure insurance portion (the "PS58 Cost"); or

- the insurer's one-year term cost.

It is important to remember that if a gift to an irrevocable life insurance trust qualifies for the annual GST tax exclusion under I.R.C. § 2642(c), all distributions from the trust, even those made to grandchildren or remote descendants, will be free from the GST tax. But to qualify for this annual exemption, the trust must meet the following conditions:

- The trust can only have one beneficiary.

- The beneficiary must be part of a generation that is at least two generations below that of the transferor.

- All trust distributions must be made to or for the benefit of the named beneficiary (or the beneficiary's estate) or must be subject to a general power of appointment held by that beneficiary.

I.R.C. § 2642(c).

Most life insurance trusts created by married grantors will not qualify for the foregoing purposes because of:

- fixed or contingent interests in the grantor or the grantor's spouse;

- multiple demand powers; or

- beneficial interests in favor of beneficiaries other than the skip person.

A generation-skipping trust that is fully subject to the GST tax will be subject to a flat 40% tax at the death of all beneficiaries in the first generation below that of the transferor. As a result, it is generally advisable to allocate GST exemption to contributions to the trust of an insurance policy or other amounts for the purpose of paying premiums.

4. (§12.46) Selecting a Trustee

The grantor of an irrevocable trust must take care in naming a trustee because the trust cannot be amended in the future. Under no circumstances should the insured be the trustee of an insurance trust, even if the insured has no beneficial interest in the trust. Treas. Reg. § 20.2042-1(c)(4). The insured serving in this role would constitute an "incident of ownership," which would cause the death proceeds to be taxed in the insured's estate under I.R.C. § 2042.

An insured's spouse can serve as the trustee of an irrevocable life insurance trust as long as the spouse does not have a general power of appointment over the policy or proceeds. But care should be taken in this regard because, theoretically, the trustee could use the trust assets to discharge the trustee's legal obligation to the trustee's children, which might cause inclusion of the proceeds in the trustee's estate. Care should also be taken to ensure that the trustee cannot use the trust income or principal to satisfy a support obligation of the insured to the insured's spouse or children.

A power to remove the trustee or to become a successor trustee may be tantamount to being the trustee for "incidents of ownership" purposes. Rev. Rul. 79-353, 1979-2 C.B. 325, *superseded by* Rev. Rul. 81-51, 1981-1 C.B. 458. But this rule will not apply if the only power retained by the grantor is the power to remove an independent corporate trustee and to appoint another independent corporate trustee in its place. Rev. Rul. 95-58, 1995-2 C.B. 191.

Retaining the limited ability to change the trustee will create flexibility in the event that the grantor chooses, in the future, to request the trustee to lend the grantor funds from the trust.

All irrevocable trust documents should also include some form of a "trust protector" clause to help provide flexibility for the future.

B. (§12.47) Employee Benefits

Life insurance as an employee benefit could be the subject of an entire chapter without exhausting the implications. Some of the major topics in this area, however, are discussed in §§12.48–12.50 below.

1. (§12.48) Group Term Life Insurance

Group term insurance is usually acquired through a single "master" policy that covers individuals, who are given certificates of participation rather than policies. Coverage is almost always furnished through a term policy. The cost—paid by the employer—of the first $50,000 of coverage is not includible in the employee's gross income. I.R.C. § 79(a). The employee must include in gross income the value of excess coverage (above $50,000) determined at the Table I rate set out in Treas. Reg. § 1.79-3(d). The employer is usually allowed to deduct the premiums paid under a group life plan. I.R.C. §§ 162(a) and 264(a).

For a group insurance plan to qualify, the plan cannot discriminate either in terms of eligibility to participate or in terms of benefits among the employer's full-time employees. I.R.C. § 79(d). If the plan discriminates in favor of key employees, they become subject to tax on the value of the entire amount of life insurance coverage on their lives. To be nondiscriminatory, the plan must meet at least one of the following four tests:

1. The plan must benefit 70% or more of all employees.
2. At least 85% of the plan participants may not be key

employees.

3. The plan must benefit employees under an employer-specified classification that the IRS approves of as being nondiscriminatory.

4. The plan must be part of a cafeteria plan meeting the requirements of I.R.C. § 125.

I.R.C. § 79(d)(3)(A).

2. (§12.49) Qualified Plan Insurance

Life insurance may be purchased by a qualified retirement plan. The tax law permits life insurance to be part of a defined contribution or defined benefit plan or profit-sharing plan to the extent that it provides for an "incidental death benefit." Life insurance is "incidental" if the death benefit is no more than 100 times the expected monthly benefit payable in accordance with a defined benefit plan.

In lieu of this 100-to-1 test, which applies to defined benefit plans, defined contribution plans must meet a specified percentage test for the insurance coverage to be deemed "incidental." Those percentages are:

- Ordinary life—50%
- Variable life—50%
- Term insurance—25%
- Universal life—25%

The percentages above are for aggregate total premiums paid—e.g., the benefit is deemed "incidental" if less than 50% of the aggregate employer contributions for the participant are spent on ordinary life insurance premiums.

If a plan participant dies while insurance is owned by the participant's account in the qualified plan, the pure insurance portion of the benefit retains its income-tax-free character under I.R.C. § 101(a). But amounts that are attributable to employer contributions toward the cash value of the policy are taxed at ordinary income rates as a qualified plan distribution when distributed.

It might be very difficult to remove any life insurance held as a part of a participant's account in a qualified plan from the decedent's gross estate under I.R.C. § 2039(a). Furthermore, the U.S. Department of Labor's position on life insurance inside a qualified retirement plan appears to indicate that the Department believes that it is a breach of the plan's fiduciary's duty to a qualified pension plan to purchase permanent life insurance. *Framingham Union Hosp., Inc. v. Travelers Ins. Co.*, 744 F. Supp. 29 (D. Mass. 1990). The Department's position seems to be that life insurance is too expensive of an investment for a pool of assets intended to be used to fund retirement benefits and that only less-expensive term insurance should be used.

The advantage of purchasing insurance inside a qualified plan is that it makes the premium, in effect, deductible. But estate tax implications usually dictate against placing needed insurance in a qualified plan unless a charity is the ultimate beneficiary or the plan participant's total estate is well under the $5.25 million estate tax exemption (for the 2013 tax year).

3. (§12.50) Nonqualified Executive Compensation Plans

An employer may elect to provide a benefit to an employee by directly paying premiums on a life insurance policy of which the employer does not have any incidents of ownership. If the premiums paid are treated as compensation, they will be deductible by the employer under I.R.C. § 162, but the employee will be required to report the entire value of the premium as ordinary compensation on the employee's form W-2 as wages. These payments will be subject to Federal Insurance Contributions Act, I.R.C. §§ 3101 *et seq.*, taxes and Federal Unemployment Tax Act, I.R.C. §§ 3301 *et seq.*, taxes.

C. (§12.51) Business Life Insurance ("Key Person Insurance") and Cross-Purchase Agreements

Life insurance in the business context may be used to facilitate the transition problems that will arise if a key person or principal stockholder dies. Typically, key person life insurance is owned by a business on the life of primary stockholders, officers, partners, or employees. Sometimes, the insurance proceeds are used by the business to help it continue the business following a key person's death. More often than not, however, the business uses the insurance proceeds to redeem or acquire the interest in the business formerly held by the deceased shareholder/partner.

1. (§12.52) Nondeductibility of Premiums

Ordinary and necessary business expenses are deductible under I.R.C. § 162; under this section, an argument might be made that key person life insurance premiums should be deductible. But I.R.C. § 264(a) denies to a business any deduction for the cost of premiums paid for insurance on the life of any officer or employees of the employer when the employer is directly or indirectly a beneficiary under the life insurance policy. The nondeductibility of insurance premiums does not depend on whether the policy is a term policy or a whole life policy; rather, nondeductibility is based on the fact that the payer of the premiums will receive a benefit if the insured dies.

2. (§12.53) Exclusion From Income of Death Proceeds

The corollary of not being able to deduct the premiums is found in I.R.C. § 101(a), which specifies that the proceeds received are not included in the business taxpayer's gross income when received unless the transfer for value problems, discussed in §12.22 above, apply to deny this benefit in some circumstances. But in most circumstances, the exceptions (safe harbors) to the transfer for value rule will apply in the business life insurance context and prevent income taxation of the proceeds.

3. (§12.54) Alternative Minimum Tax and Earnings and Profits Problems Caused by Receipt of Death Proceeds

If a corporation owns a life insurance policy on a shareholder/employee, even though the proceeds are not included in the gross income of a C corporation, these proceeds may affect the corporation's liability for the AMT (alternative minimum tax). I.R.C. §§ 55–59. The effective rate of tax for AMT purposes is about 15% of items included in adjusted current earnings. *See* I.R.C. § 56(g). One of the many items included in adjusted current earnings is the corporation's receipt of earnings that, although not included in the corporation's gross income for income tax purposes, nevertheless are part of its earnings and profits. I.R.C. § 56(g)(4)(B)(i). A corporation's adjusted current earnings will include death benefits paid to the extent that they exceed the corporation's adjusted basis in the contract. Treas. Reg. § 1.56(g)-1(c)(5)(v). Death proceeds received by a corporation on a key person life insurance policy will increase the corporation's earnings and profits to the extent that the proceeds received exceed premiums paid. Rev. Rul. 54-230, 1954-1 C.B. 114; *Golden v. Comm'r*, 113 F.2d 590 (3rd Cir. 1940). One solution to this problem might be to buy a larger life insurance policy to take into account the taxes that will have to be paid and that will be attributable to the receipt of the death proceeds by the corporation. Another solution might be to own the insurance outside of the corporation (see the discussion in §12.55 below) if the purpose of the insurance is to provide funds with which to purchase the decedent's interest in the business.

4. (§12.55) Buy/Sell Agreements—Formats

The typical corporation buy/sell agreement is written for the purpose of providing a means and structure with which to effect the purchase of a deceased owner's former interest in the business. Both "key person" and "redemption/cross-purchase" life insurance may be necessary for a satisfactory business succession plan. Buy/sell agreements can be structured in the form of a redemption or entity agreement whereby the entity acquires the deceased owner's interest. Alternatively, a buy/sell agreement may be structured between the owners as individuals, or it may involve a trust or partnership formed primarily to acquire this type of insurance. These so-called "cross-purchase" arrangements may also have the benefit of increasing the surviving shareholders' income tax basis in the corporation stock.

It is important to note that if the persons involved in a corporate cross-purchase arrangement also are partners in a partnership, transfers of life insurance policies between them will avoid the transfer for value problem, even though the partnership has no relationship to the corporation. The partnership merely needs to be bona fide with some legitimate purpose and operation to create a mechanism to avoid the transfer for value problem. *Swanson v. Comm'r*, 518 F.2d 59 (8th Cir. 1975), *aff'g* 33 T.C.M. (CCH) 296 (1974).

For example, assume that there are three shareholders who want to create a trust to apply for and buy life insurance on each of the three shareholders of the corporation because they want to avoid the AMT and earnings and profits problems discussed in §12.54 above, or they want to achieve some income tax basis step-up in the corporation, or both. On the death of any one shareholder, the trustee of this trust would be required to collect the life insurance proceeds and distribute the proceeds to the two surviving shareholders, who would then use these proceeds to pay for the stock of the deceased shareholder. After the death of the first shareholder, arguably, there is a transfer for value of the other two life policies because of the shift in the remaining two shareholders' equitable interests in the trust. This would probably be enough to create a transfer for value problem, at least after the death of the first shareholder, and assuming that the remaining two shareholders want to continue the trusteed cross-purchase agreement. But if the shareholders had separately entered into a general partnership to invest in the stock market or for some other bona fide purpose, even though holding a relatively negligible amount of property, the transfer for value problem would be avoided. This transfer, because of the fact that the shareholders are partners in a partnership, qualifies under I.R.C. § 101(a)(2) in accordance with the "safe harbors" applicable to insurance owned by partnerships or partners on each other.

As an alternative to the above trust arrangement, the three shareholders could have each purchased two policies on the lives of the other two shareholders. This would require the acquisition of six policies rather than three policies and would have substantially increased the life insurance premiums and administrative costs involved. The use of a trusteed arrangement plus a partnership avoids this problem. I.R.S. P.L.R. 9235029 (Aug. 28, 1992). Furthermore, the IRS has ruled that a partnership formed solely to own cross-purchase life insurance on the lives of two corporate shareholders qualifies as exempt from the application of the transfer for value rule. I.R.S. P.L.R. 9309021 (Mar. 5, 1993).

Trusteed buy/sell agreements have become more popular because of Private Letter Rulings that have confirmed that the transfer of policies to a trust or a beneficiary who is a partner of the insured is not subject to the transfer for value rules, even if the partnership is not connected with the corporation whose shares are the subject of the buy/sell agreement. *Swanson*, 518 F.2d 59; I.R.S. P.L.R. 9511009 (Mar. 17, 1995).

5. (§12.56) Typical Flaws of Buy/Sell Agreements

In an article in the *Practical Tax Lawyer*, one commentator suggests that the typical buy/sell agreement has four potentially serious flaws:

1. Older shareholders can become uninsurable as time goes by such that it will not be possible to purchase additional necessary insurance.

2. As the value of the business rises, the decedent's estate tax liability may increase also, but the buy/sell agreement may not take this into account or might not provide for an increasing price and value to the successor owners.

3. The valuation techniques used in buy/sell

agreements ignore minority discount valuation options and, thus, potentially increase estate tax liability.

4. The typical buy/sell agreement tends to ignore a possible future appreciation in the value of a business.

Robert E. Hales, *To Buy-Sell or Not to Buy-Sell*, 9 PRAC. TAX LAW. 31 (1994).

6. (§12.57) Insurance Proceeds as Compensation

Care should be taken in the drafting of a buy/sell agreement funded by life insurance to accurately categorize the nature of the payment being made. It is possible for the IRS to categorize payments made to redeem a deceased owner's business interest as the payment of income in respect of a decedent and to tax the payments as ordinary income for income tax purposes instead of long-term capital gain or as payment for redemption of a capital interest in the business. *Estate of Cartwright v. Comm'r*, 71 T.C.M. (CCH) 3200 (1996).

7. (§12.58) S Corporations

S corporations (corporations that elect to be taxed under Subchapter S of the Internal Revenue Code) have their own set of problems when it comes to owning life insurance policies. Although these rules are less burdensome than those applicable to Subchapter C corporations, they are no less complex.

An S corporation that owns a life insurance policy on the life of an employee or shareholder is not entitled to any deduction for its premium payments under the general rules of I.R.C. § 264. Thus, paying insurance premiums out of S corporation income will not reduce the S corporation's taxable income. Naturally, it will reduce the cash otherwise distributable to the shareholders. It may also have the unfortunate effect of reducing the shareholders' basis in their stock.

The effect on a shareholder's basis as a result of premiums paid by the corporation is complex: With a whole life policy owned by the corporation, cash values of the policy will increase each year. The excess of the premiums paid over the amounts of the cash value increase will reduce the shareholder's basis, but the shareholder's basis should increase by the amount of the cash value increase. But a term insurance policy will not have any cash value; thus, when an S corporation pays a premium on a term life insurance policy, the shareholders may be required to reduce the shareholders' basis because of this nondeductible expense. I.R.C. § 1367(a)(2).

A shareholder's basis in an S corporation's shares is increased by the shareholder's pro rata share of the income of the corporation, regardless of whether the income is taxable or nontaxable. Accordingly, life insurance proceeds paid to the corporation at an insured's death will result in an increase in the shareholder's basis in their shares of stock. I.R.C. § 1367(a)(1).

If the life insurance contract is owned by the employee, including a shareholder employee of an S corporation, but the S corporation pays the premium, the payment will probably be treated as though the corporation paid additional compensation to the employee for services, and the compensation will be taxed to the employee as ordinary income.

There is no AMT on income or receipts of an S corporation; thus, the AMT and earnings and profits problems faced by a C corporation are avoided through the S election. Once a corporation receives life insurance proceeds and distributes them to the shareholders, the proceeds should be income tax free to the shareholders with a corresponding basis increase and then decrease in the shareholder's shares. But if the corporation has accumulated earnings and profits from pre-S election years, the receipt of life insurance proceeds and the later distribution of the proceeds will be tax free only until the shareholder's accumulated adjustments account is reduced to zero. Any excess above this amount may be taxed as a dividend to the extent of the corporation's earnings and profits.

As alluded to above, if an S corporation's shareholders enter into a cross-purchase agreement under which they own life insurance policies on each other's lives, upon a shareholder's death, they will purchase the stock of the deceased shareholder and receive a purchase price basis in the stock purchased. If the S corporation owns the life insurance policy, the shareholders will receive a step-up in basis equal to the value of the insurance proceeds paid to the corporation, but this basis will be allocated pro rata among all shareholders, including the deceased shareholder. This results in an allocation of basis to the deceased shareholder's estate, which the estate may not be able to use because the estate will already have a step-up in basis under I.R.C. § 1014.

One possible solution to this problem is to terminate the corporation's fiscal year upon the death of the deceased shareholder and then redeem the stock immediately thereafter and before the life insurance proceeds are received, so that when the proceeds are collected, the increased basis inures solely to the benefit of the remaining shareholders.

D. (§12.59) Charitable Giving With Life Insurance

Charitable giving through the use of life insurance is often suggested to generous individuals who desire to assure a charity of a specific gift upon the donor's death.

1. (§12.60) Tax Deduction, Valuations of Gifts, and Tax Effects

A gift of a life insurance policy to a charity will be subject to the same deduction limitations as other charitable gifts. The policy will be valued in the same manner as a gift of the policy would be valued if given to a noncharitable donee. If the gift is irrevocable and complete and the donor thereafter continues to pay premiums, the value of the policy plus the premiums thereafter paid should be deductible to the donor under I.R.C. § 170. Rev. Rul. 58-372, 1958-2 C.B. 99.

A direct payment of premiums on life insurance policies is a gift "for the use" of the charity and will be deductible subject to the 30% limitation set forth in I.R.C. § 170(b)(1)(B)(i). If a direct cash gift had been made to the charity instead with the charity paying the premium, the deduction would be subject to the 50% limitation generally prescribed in I.R.C. § 170(b)(1)(A).

The deduction for the value of a life insurance policy is limited to the taxpayer's adjusted basis in the policy or, if less, the policy's fair market value. *Tuttle v. United States*, 305 F. Supp. 484 (N.D.N.Y. 1969). If the life insurance policy proceeds are included in an insured's gross estate under I.R.C. § 2042, but the proceeds pass to a qualified charity, the estate will be entitled to a charitable contribution deduction. I.R.C. § 2055.

2. (§12.61) Tax Effects on Charities

The charity's attorney should take care to make certain that a particular gift will not cause the charitable organization to lose its tax exemption. Private foundations may need to be concerned about receiving life insurance policies if there is a loan against the cash surrender value that is assumed by the charity. Rev. Rul. 80-132, 1980-1 C.B. 255. A charity that borrows against the cash surrender value of a life insurance policy to invest in other assets may create "debt-financed income" that may be taxable to the charity. I.R.C. §§ 511–515.

3. (§12.62) Achieving Income Tax Benefits for Heirs

With the advent of the $5.25 million federal estate tax exemption in 2013, it is much less likely that life insurance proceeds will be subject to estate tax. Thus, if a decedent designates a charity as beneficiary of all or a portion of the decedent's life insurance, there will be no effective income or estate tax deduction available.

To achieve a measure of tax benefit for the life insurance proceeds for nontaxable estates, one approach would be to designate either the insured's spouse or the insured's children, or both, as beneficiary of the life insurance, with the expression of the insurer's "desire" that the beneficiaries in turn give all or a portion of the proceeds to charity. By proceeding in this fashion, the beneficiaries will receive an income tax deduction for the donated proceeds, without any corresponding income to report.

If the insured has a taxable estate, the same policy can be owned by the children to keep the proceeds from being subjected to estate tax. If the insured is married, any proceeds passing to the surviving spouse would, of course, be entitled to the unlimited estate tax marital deduction.

E. (§12.63) More on Split-Dollar Life Insurance Plans

The IRS issued new regulations governing the tax consequences of split-dollar plans ten years ago. These final regulations only apply to split-dollar arrangements entered into or materially modified after September 17, 2003.

1. (§12.64) IRS Notice 2002-8

IRS Notice 2002-8, 2002-1 C.B. 398, governs pre-September 18, 2003, arrangements; Notice 2002-8 divides pre-September 18, 2003, arrangements into two categories: arrangements created before and after January 28, 2002. Pre-January 28, 2002, arrangements are permitted to continue to use the insurer's lower published premiums rates for income and gift tax purposes, whereas post-January 28, 2002, plans may use the lower rates only if the insurer actually discloses them to policy applicants and regularly sells life insurance using these lower rates. Otherwise, the arrangements must determine the income and gift consequences using the higher Table 2001 rates published in Notice 2001-10, 2001-1 C.B. 459.

Subject to the above-described premium rates, ongoing pre-September 18, 2003, arrangements may, arguably, operate without the participants recognizing, as income, the equity buildup within the policy that exceeds the amount required to be reimbursed to the payor. But the safest strategy would be to determine an exit strategy for these so-called "equity split-dollar" arrangements because the IRS has stated that no inference is to be drawn from Notice 2002-8 with respect to the tax consequences of pre-September 18, 2003, equity split-dollar arrangements.

2. (§12.65) Final Regulations

The final regulations tax new split-dollar arrangements under one of two "regimes":

1. The economic benefit regime—typically applicable to endorsement arrangements whereby the employer (or other policy owner) pays the premium, thereby providing a benefit to the employee or other nonowner

2. The loan regime—the employer or other nonowner pays the premium on a policy owned by the employee or other owner, who or which typically assigns the policy back to the employer or other nonowner as collateral to secure the repayment of the amount advanced by the employer or other nonowner

a. (§12.66) Endorsement Plans ("Economic Benefit Regime")

New split-dollar plans organized under an endorsement arrangement have the term benefit valued and taxed using a premium factor published by the IRS, currently Table 2001, published in Notice 2001-10 and Notice 2002-8. Equity, if any, is valued and taxed each year as it develops. Treas. Reg. § 1.61-22.

b. (§12.67) Collateral Assignment Plans ("Loan Regime")

New split-dollar plans organized under a collateral assignment arrangement are taxed like a loan, with the executive treated as the borrower and the employer as the lender. Treas. Reg. § 1.7872-15. When the employer pays the premium, the amount so paid is treated as loaned to the employee.

F. (§12.68) Purchasing Life Insurance on Younger Generation Family Members

Especially in high net-worth situations, purchasing and owning life insurance policies on younger generation family members can make sense from an estate planning perspective. Not only would the older generation family member be helping provide for the payment of estate taxes of the next generation, but if the cash surrender value of the policy is substantially less than the amount of premiums expended by the senior generation family members, the value of the latter's taxable estate will actually decrease, thereby generating significant estate tax savings.

G. (§12.69) Use of Decanting Trusts

The obvious largest negative aspect associated with irrevocable life insurance trust planning is just that—the trusts holding the life insurance policies are irrevocable. Circumstances and laws change, and trust provisions that may have made perfect sense ten years ago may make much less sense now.

To the potential rescue is the new Missouri decanting statute, § 456.4-419, RSMo Supp. 2012. The legislation permits the establishment of a new irrevocable trust, followed by the transfer of assets from the existing irrevocable trust to the new one. There are obviously significant restrictions to these "decanting trusts," however, and the trusts must also be carefully crafted to avoid any adverse estate, gift, GST, or income tax consequences upon their funding.

IV. Forms

A. (§12.70) Joint Irrevocable Life Insurance Trust Agreement

Irrevocable Life Insurance Trust
(Which Owns a Second-to-Die Policy on
Grantors Who Are Husband and Wife)

John and Jane Doe
Irrevocable Life Insurance Trust Agreement

On this _____ day of ________________, 20___, John Doe and Jane Doe, husband and wife, of ______________, _______________ County, Missouri, (hereinafter referred to as the "Grantors") hereby transfer and assign to John Smith and Joe Smith, as Co-Trustees and their successors in trust (hereinafter referred to collectively as the "Trustee"), *in trust*, the sum of Ten Dollars ($10.00), together with such other and additional property as may be contributed from time to time by the Grantors or other persons to the Trustee, all as hereafter described. The trust property so identified, any property added to the trust in accordance with the provisions of this instrument, and all investments and reinvestments thereof ("trust principal") shall be held upon the following terms:

Article I
Name of Trust

This document shall be known as the "John and Jane Doe Irrevocable Life Insurance Trust Agreement," and the initial trust hereby created shall be known as the "John and Jane Doe Irrevocable Life Insurance Trust." The Grantors are John Doe and Jane Doe, husband and wife. The effective date of this trust is ________________, 20___.

Article II
Irrevocability

This trust and all interests in it are irrevocable, and the Grantors have and retain no power to alter, amend, revoke, or terminate any trust provision or interest, whether under this trust or under any statute or other rule of law.

Article III
Annual Demand Power

During the Grantors' joint lifetimes, and during the lifetime of the surviving Grantor, the following demand (withdrawal) powers shall exist with respect to contributions to the trust:

A. Immediately following any contribution to this trust, each of the then-living children and grandchildren of John Doe and Jane Doe shall have the right to withdraw an amount equal to a proportionate share of the contribution. The proportionate share will be the amount of the contribution divided by the number of then-living children and grandchildren of John Doe and Jane Doe at the time of the contribution. If any of the children or grandchildren of John Doe and Jane Doe demand and receive a distribution in excess of the amount the child or grandchild is authorized to receive under this paragraph A, the Trustee shall immediately notify the child or grandchild in writing, requiring the prompt repayment of the excess amount. This demand power shall take precedence over any other power or discretion granted the Trustee or any other person by this agreement.

B. With respect to the demand powers created under this Article, the following rules shall apply:

    1. As of the date this trust was created, John Doe and Jane Doe have two children: John Doe, Jr. and Mary Doe. The Grantors have no grandchildren. Each of John Doe's and Jane Doe's then-living children shall have the right to

exercise the demand powers specified in this Article by a written request delivered to the Trustee in a timely manner.

2. If any such child is unable to exercise their demand power under this Article because of a legal disability, the child's legally authorized personal representative, including (but not limited to) a guardian, committee, or conservator, may make the demand on the beneficiary's behalf, and if there is no legally authorized personal representative, the Trustee shall designate an appropriate adult individual who may make the demand on the child's behalf. But in no event can either Grantor make a demand for any of the above-named children, regardless of the Grantor's relationship to the child.

3. The Trustee must reasonably notify the child (or the person who has the authority to exercise a child's demand power) of the existence of the power and of any contributions made to the trust that are subject to the power. After receiving such notice at least once, an adult beneficiary may waive further notice by an instrument in writing delivered to the Trustee.

4. The demand powers created under this Article are generally noncumulative and shall lapse on the earlier of the last day of the calendar year in which the contribution is made or 60 calendar days following the date of the transfer to which these powers relate. But a demand power that is not exercised within the 60-day period shall continue to be exercisable by its holder to the extent that the amount subject to the exercise exceeds the greater of $5,000 or 5% of the aggregate value of the assets out of which the demand power could be satisfied. This continuing demand power shall lapse annually

to the extent of the greater of $5,000 or 5% of the aggregate value of the assets out of which the demand power could be satisfied.

5. The Trustee may satisfy any demand under this Article for a distribution by distributing cash, other assets, or fractional interests in other assets as the Trustee deems appropriate. Without limiting the Trustee's power to select assets to satisfy a demand, the Grantors prefer that cash or tangible assets be distributed before life insurance policies and other intangible assets, unless the Trustee decides that a different selection is warranted.

6. "Contribution" means any cash or other assets transferred to the Trustee to be held as part of the trust funds. The amount of any contribution is its federal gift tax value, as determined by the Trustee at the time of the transfer.

Article IV
Trustee's Duties During the Grantors' Joint Lifetimes and During the Lifetime of the Surviving Grantor

During the Grantors' joint lifetimes, and during the lifetime of the surviving Grantor, the Trustee shall hold and administer all funds remaining after the exercise or lapse of all demand powers created under Article III, using some or all of the trust's net income and principal to pay premiums on policies of life insurance on the lives of the Grantors, and adding to principal any income not so used. In addition, the Trustee may distribute to and among the descendants of John Doe and Jane Doe (in whatever proportions the Trustee deems appropriate) so much of the trust principal and income (including all or none) as the Trustee deems appropriate for any purpose, provided, however, that the Trustee may not make any distribution to or for the Trustee's own benefit; nor may the Trustee make any distribution to or for the benefit of any individual if the distribution would discharge either Grantor's legal obligation to support that individual. Furthermore, the Trustee shall not use any trust income or principal in a manner that would give either Grantor any pecuniary benefit.

Article V
Trustee's Duties After Death of Both Grantors

A. After the death of both Grantors, the Trustee is authorized, although not required, to purchase assets from, make loans to, or otherwise deal without restriction with the probate estate of either Grantor or any other trust created by either Grantor, even though one or more of the Co-Trustees hereunder may also be acting as a trustee of such other trust or as a personal representative of either Grantor's probate estate. The determination of the Trustee with respect to the desirability of any such purchase, loan, or other transaction shall be conclusive on all persons. The Trustee shall also distribute any portion of the trust principal that is includible in either Grantor's gross estate for federal estate tax purposes to the personal representative of either Grantor's probate estate (or to the Trustees of the pertinent Grantor's Revocable *Inter Vivos* Trust). But if any portion of the principal of this trust is *not* so includible in either Grantor's gross estate for federal estate tax purposes, the portion that is not so includible (up to and including all of the principal of this trust) shall be retained by the Trustee to be held and distributed by the Trustee as hereafter prescribed.

B. After any distribution required under paragraph A of this Article, if any child of John Doe or Jane Doe or any descendant of John Doe or Jane Doe survives both of the Grantors, the remaining portion of the principal and undistributed net income as accumulated as of the date of death of the last to die of the Grantors and that is not required to be distributed as set forth above in paragraph A shall be held and distributed by the Trustee in accordance with the following terms and conditions:

1. After the death of both Grantors, the Trustee is authorized, although not required, to purchase assets from, make loans to, or otherwise deal without restriction with the probate estate of either Grantor or any other trust created by either Grantor, even though one or more of the Co-Trustees hereunder may also be acting as a trustee of such other trust or as a personal representative of either Grantor's probate estate. The determination of the Trustee with respect to the desirability of any such purchase, loan, or other transaction shall be conclusive on all persons.

2. If both of the children of John Doe and Jane Doe survive the Grantors, the remaining principal and undistributed accumulated income shall be divided into two equal shares such that there shall be one equal share created for the benefit of John Doe, Jr. and one equal share created for the benefit of Mary Doe. Each share created for a child of the Grantors named above shall be distributed as hereafter prescribed in this paragraph B.

3. Each of the above-named children who survive both the Grantors shall be entitled to receive the child's share of this trust, free of trust, as soon as practicable after the death of the last to die of both of the Grantors, and if at such time all of the children survive, all assets in this trust shall be distributed and this trust shall terminate.

4. If either of the children of John Doe or Jane Doe predeceases either Grantor, but at the time the child dies, the child is survived by one or more descendants, those descendants of the deceased child shall be entitled to receive the share of this trust that the deceased child otherwise would have received. In this event, the deceased child's

share shall be held for and distributed to the deceased's child's descendants per stirpes (subject to the other provisions relating to withholding this distribution as hereafter prescribed in subparagraphs 7 and 8).

5. If either of the children of John Doe or Jane Doe predeceases either Grantor without surviving descendants, the gift to that deceased child who died without surviving descendants shall lapse and shall instead be given to the remaining child of John Doe and Jane Doe who survives both Grantors, free of trust. If the remaining child also predeceases either Grantor but is survived by descendants, the child's descendants shall receive the deceased child's share of this trust, per stirpes, and in the manner hereafter prescribed.

6. The Trustee is authorized to make distributions to a descendant of a deceased child of John Doe and Jane Doe who has not attained the age of 30 years out of that descendant's share of this trust for undergraduate, graduate, or professional education, as well as for that descendant's health, education, support, and maintenance. Any distribution shall be charged as an "interest-free" loan or advancement against the distribution, if any, that otherwise will be made to that descendant when that descendant attains the age of 30 years.

7. If a descendant of a deceased child becomes entitled to receive a share of this trust, the share shall be held by the Trustee until the descendant has attained the age of 30 years, at which time it shall be distributed to the descendant, free of trust. While the share is being held for the descendant who has not attained the age of 30 years, the Trustee may distribute such portions of the income and

principal of the share for the descendant's benefit as the Trustee deems appropriate for the descendant's health, education, support, and maintenance, taking into consideration all circumstances and factors deemed pertinent by the Trustee. Any undistributed net income shall be accumulated and added to principal, as from time to time may be determined by the Trustee. If the beneficiary for whom such a trust is held dies before complete distribution of the trust, the remaining net income and principal of the trust shall be held for and be distributed to the beneficiary's surviving descendants, if any. If no such descendants survive the termination of this trust, the gift to those descendants shall lapse.

8. If both children of John Doe and Jane Doe named above predecease the Grantor without surviving descendants (and only in this event), the gifts to the deceased children shall lapse, and the remaining principal and undistributed accumulated income shall be divided equally among the next of kin of the last surviving Grantor. In this event (and only in this event), all shares created under this subparagraph shall be distributed, free of trust, to the contingent beneficiaries specified in this subparagraph 9 as soon as reasonably practicable after the death of the last to die of the Grantors.

C. The aggregate of any advancements to or for the benefit of a descendant of John Doe or Jane Doe under paragraph B of this Article shall be added to the value of the trust at the death of the second Grantor to die and shall be charged without interest against the value of the distribution, if any, to that child or the descendants of the child under paragraph B of this Article. But nothing contained in this trust shall be construed as requiring any descendant of John Doe or Jane Doe, or the estate of a descendant, to refund at any time, in whole or in part, any payment so treated as an advancement.

D. The Trustee may elect to withhold any share of this trust otherwise distributable under this Article to a beneficiary who has not attained the age of 30 years and may retain the property for that beneficiary in a separate trust named for the beneficiary, to be distributed to the beneficiary when the beneficiary attains the age of 30 years, or before then if the Trustee so elects. The Trustee shall apply as much of the net income and principal of the trust so retained as the Trustee determines to be required from time to time for the health, support in reasonable comfort, and education of the beneficiary for whom the trust is established, considering all circumstances and factors deemed pertinent by the Trustee. Any undistributed net income shall be accumulated and added to principal, as from time to time determined by the Trustee. If the beneficiary for whom the trust is named dies before complete distribution of the trust, the remaining net income and principal of the trust shall be distributed to the beneficiary's estate.

Article VI
Interests Vesting in a Minor

If, when any trust created by this instrument ends, any principal vests in absolute ownership in any minor beneficiary, the Trustee may, if the Trustee deems it appropriate to do so, hold this interest in trust until the beneficiary attains the age of 21 years, paying so much (including all or none) of the trust's net income and principal to the beneficiary as the Trustee deems appropriate for the beneficiary's health, education, support, and maintenance, adding to principal any undistributed income. The Trustee may make such payments to the beneficiary, or to the beneficiary's parent or guardian, or the person with whom the beneficiary resides, without having to look to the proper application of those payments. The Trustee may also make any payments to a custodian (who may be the Trustee) under any applicable Uniform Transfers (or Gifts) to Minors Act. When the beneficiary attains the age of 21 years, the Trustee will pay the beneficiary all of the remaining trust funds, and this trust will end. If the beneficiary dies before attaining the age of 21 years, the Trustee will pay all of such funds to the beneficiary's estate. The authority conferred on the Trustee is a power only and will not operate to suspend absolute vesting of any property in such beneficiary.

Article VII
Spendthrift Clause

To the maximum extent permitted by law, all beneficiaries' interests in this trust shall not be subject to anticipation, pledge, or assignment or to any claim by any creditor or to seizure by any beneficiary's creditor. No beneficiary shall have any right to assign, pledge, anticipate, or encumber any benefit under this trust until this trust has been actually distributed to the beneficiary by the Trustee, except to the extent specified above in Article III.

Article VIII
Uneconomical Trusts

If, after the death of both Grantors, any trust created under this instrument ever shall have a fair market value of $25,000 or less, the Trustee may terminate the trust and distribute the trust funds to the persons to whom the Trustee then must or may pay the trust's income, in proportion to their interests in trust income or, if such interests are indefinite, equally to such beneficiaries without regard to their relationship to the Grantors. For purposes of this paragraph, any beneficiary entitled to receive support is entitled to receive income.

Article IX
Merger, Consolidation, and Division

For convenience of administration or investment, the Trustee of any trusts created hereunder may:

A. invest the assets of multiple trusts in a single fund, assigning them undivided interests in the common fund, dividing the income proportionately and accounting for them separately;

B. merge or consolidate any trust created hereunder together with any other trusts having the same Trustee and substantially the same dispositive provisions; and

C. divide any trust created hereunder into two or more separate trusts, each such trust to contain a fractional share of the assets of the trust before the division.

Article X
Definitions

A. At the time this trust agreement was executed, John Doe and Jane Doe had two children: John Doe, Jr. and Mary Doe. This trust is intended to benefit the descendants of John Doe and Jane Doe. In determining relationships to the Grantor or the Grantor's spouse, the terms "child," "children," and "descendants" include both those now and subsequently born or legally adopted by John Doe or Jane Doe. But an adoption must be bona fide and done to establish a familial relationship, and no adoption shall be recognized if the purpose and intent of the adoption is to defeat the clear intents and purposes of this trust. The adoption of a person who has attained the age of 18 years or more at the time of the adoption shall be presumed to have been accomplished for the purpose of defeating the purposes and intents of this trust agreement unless the contrary is clearly and unequivocally shown. A person in gestation who is later born alive shall be treated as alive during the period of gestation for purposes of determining: (1) whether any person has died without leaving descendants surviving him or her; (2) the right to distributions on the termination of a trust created under this instrument; and (3) any person's right to share in required principal distributions, although for all other purposes this person's rights accrue only from the date of birth.

B. No person shall be deemed to have survived both Grantors for purposes of this trust unless the person is living 30 days after the date of the death of the last Grantor to die, as determined by applicable legal death certificates.

C. "Health, education, support, and maintenance" shall be construed in such a manner as to be an ascertainable standard for federal estate and gift tax purposes, such that the exercise, release, or lapse of a power that is limited by this standard will not be taxable for federal estate and gift tax purposes. In this regard, "support" and "maintenance" are synonymous, shall not be limited to the bare necessities of life, and shall be the same as "support and maintenance in reasonable comfort." "Education" shall include (but not be limited to) college and professional education. "Health" shall include (but not be limited to) medical, dental, hospital, and nursing expenses and expenses of invalidism. Unless expressly indicated to the contrary elsewhere in this instrument, no Trustee shall be required to consider a beneficiary's other readily available resources in making a distribution for the beneficiary's health, education, support, and maintenance.

D. All tax-related terms mean the same things in this trust instrument as they mean in the Internal Revenue Code of 1986, as amended.

E. "Per stirpes" means by right of representation, and a disposition to an individual and the individual's "descendants per stirpes" requires that the individual's children, whether or not living at the time of the disposition, be treated as the original generation and that a further subdivision be made at each succeeding generation.

F. There is only one signed original of this trust. Anyone may rely on a copy of this document as certified by a notary public or similar official to be a true copy of the signed original (and on the amendments or other writings, if any, endorsed on or attached to it) to the same effect as if the copy were the signed original. Anyone may rely on any statement of fact certified by anyone who appears from the original document or a certified copy of it to be a Trustee hereunder.

Article XI
Trustee's Powers

A. The Trustee is empowered to do the following, exclusively in the Trustee's fiduciary capacity and discretion:

1. To hold and retain all or any property received from any source, without regard to diversification, risk, productivity, or the Trustee's personal interest in the property in any other capacity, and to keep all or part of the trust property at any place within the United States or abroad

2. To invest and reinvest the trust funds (or leave them temporarily uninvested), in any type of property and every kind of investment, including (but not limited to) corporate obligations of every kind, preferred or common stocks, securities of any regulated investment trust, and partnership interests, regardless of whether the securities and properties are of the kind and class authorized by law

3. To participate in the operation of any business or other enterprise and to incorporate, dissolve, or otherwise change the form of the business

4. To deposit trust funds in any commercial savings or savings and loan accounts

5. To borrow money for any reasonable trust purpose and upon such terms, including (but not limited to) interest rates, security, and loan duration, as the Trustee deems advisable

6. To lend trust funds to such persons and on such terms, including (but not limited to) interest rates, security, and loan duration, as the Trustee deems advisable, provided, however, that the Trustee may not lend money to either Grantor's estate without receiving adequate security and an adequate rate of interest

7. To sell or otherwise dispose of trust assets, including (but not limited to) trust real property, for cash or credit, at public or private sale, and with such warranties or indemnifications as the Trustee deems advisable

8. To buy assets of any type from any person on such terms, including (but not limited to), cash or credit, interest rates, and security, as the Trustee deems advisable, provided, however, that the Trustee may not buy assets from either Grantor's estate other than at their fair market value

9. To improve, develop, manage, lease, or abandon any trust assets, as the Trustee deems advisable

10. To:

    - Vote all stocks and exercise all rights incident to the ownership of stocks, bonds, or other securities or properties held in the Trust Estate and to issue proxies to vote these stocks and to exercise such rights

    - Enter into voting trusts for such period and upon such terms as the Trustee may determine

    - Sell or exercise any and all subscription rights and stock options

- Sell or retain any and all stock dividends

- Consent to or join in any plan of reorganization, readjustment, merger, consolidation, or liquidation with respect to any corporation whose stocks, bonds, or other securities are a part of the Trust Estate, including becoming a member of any stockholders' or bondholders' committee

- Accept and hold any new securities issued in accordance with any plan of reorganization, readjustment, merger, consolidation, or liquidation

- Pay any assessments on stocks or securities or relinquish the stocks or securities

- Otherwise exercise any and all rights and powers and deal in and with the securities and properties held in the Trust Estate in the same manner and to the same extent as any individual owner and holder thereof might do

11. To hold any and all stocks, bonds, notes, mortgages, or other property in bearer form, in the name of the Trustee, individually, or in the name of the trust or in the name of a nominee

12. To claim expenses as income tax deductions or to permit the claiming thereof as estate tax deductions when an election is permitted by law, without thereafter making any adjustment between income and principal because of any such determination

13. To directly pay for or to reimburse the Trustee for any travel or transportation expenses

incurred by the Trustee in discharging the obligations imposed on the Trustee by this trust

14. To hold property in the name of any Trustee or any custodian or nominee, without disclosing this trust, but the Trustee is responsible for the acts of any custodian or nominee so used

15. To pay and advance money for the trust's protection and for all expenses, losses, and liabilities sustained in its administration

16. To prosecute or defend any action for the protection of the trust, the Trustee in the performance of the Trustee's duties, or both and to pay, contest, or settle any claim by or against the trust or the Trustee in the performance of the Trustee's duties

17. To engage agents, including legal counsel, accountants, investment advisors, custodians, appraisers, and other experts for the proper administration of this trust and to compensate these persons for their services out of income or principal making up the trust estate

18. To make allocations of charges and credits between principal and income of the trust estate, in the Trustee's sole discretion

19. To distribute trust assets in kind or in cash

20. To execute and deliver any instruments necessary or useful in the exercise of any of these powers

21. To exercise those powers granted by Sections 456.8-801–456.8-817, RSMo (which are incorporated herein by reference)

B. During the administration of either Grantor's estate under applicable state law, the Trustee may use the trust funds, in the Trustee's discretion, to lend money to and buy assets from either Grantor's estate, on terms and conditions as the Trustee deems to be in the best interests of the trust's beneficiaries. The Trustee shall not, however, make grants to either Grantor's estate or otherwise distribute funds except through bona fide loans or purchases, it not being the Grantors' intention to make any persons who are not specifically so identified in this instrument the beneficiaries of any trust created under this instrument. If no personal representative is appointed with respect to either Grantor's estate under applicable state law, the "administration" of either Grantor's estate will be deemed to include the settlement of debts, claims, and taxes with respect to either Grantor's estate by the trustee of any revocable trust created by either Grantor or by any other person in actual possession of assets in which either Grantor had a legal or equitable interest at the time of their death.

C. With respect to any life insurance policies held as part of the trust funds, the following special rules shall apply:

   1. The Trustee may, in the Trustee's discretion, pay any premiums or other charges from trust income or principal. If the trust funds are inadequate to pay these premiums or charges, the Trustee may, in the Trustee's discretion, do one or more of the following:

      - Use any automatic premium loan feature

      - Borrow against any policy cash reserves (whether or not on the policy for which premium or charges will be paid)

      - Elect any automatic nonforfeiture feature

The Trustee has no duty to do any of these unless the Trustee shall have received specific written notice that a premium or charge has not been paid.

2. Any additional insurance policies, no matter how acquired (including, but not limited to acquisition by gift, conversion, reissue, or consolidation), should be listed on Schedule A, but failure to do so does not affect the trust's policy holdership.

3. The Trustee may, in the Trustee's discretion, refuse to enter into or maintain any litigation, endorse policy payments, or take other action respecting any trust insurance policies until the Trustee has been indemnified against all expenses and liabilities that, in the Trustee's judgment, may be involved in such action.

4. The Trustee does not need to inquire whether the Trustee or the trust has been designated the beneficiary of any insurance policy or other death benefit, and the Trustee does not need to act with respect to these policies until receipt of written notice that the Trustee or the trust is a beneficiary.

D. The Trustee may expend payments for the benefit of a minor or disabled beneficiary or make such payments to this beneficiary, or to the beneficiary's parent, guardian, or personal representative or the person with whom the beneficiary resides, without having to look to the proper application of those payments. This paragraph does not limit the Trustee's powers and must be construed to enable the Trustee to give each beneficiary the fullest possible benefit and enjoyment of all of the trust income and principal to which the beneficiary is entitled under this agreement.

Article XII
The Trustee

A. Joe Smith and John Smith are hereby designated as the Co-Trustees of this trust. If either Joe Smith or John Smith becomes unable to act as Co-Trustee under this Trust for any reason, the sole remaining Trustee named above shall be permitted to serve as sole Trustee under this Trust, without the necessity of appointing a successor Co-Trustee. If both Joe Smith and John Smith are unable or refuse to act as Trustee under this trust, the Grantors' son, John Doe, Jr., and the Grantors' daughter, Mary Doe, shall become the successor Co-Trustees of this Trust.

B. The Trustee (and any successor) may designate any individual or institution as a Co-Trustee, or as successor Trustee, by a written instrument. Any Co-Trustee or successor Trustee may, without liability, accept without examination or review the accounts rendered and the property delivered by any predecessor Trustee. Each successor Trustee has the same title, powers, and duties as the Trustee succeeded, without any additional conveyance or documentation. A Co-Trustee so named shall serve only as long as the Trustee who appointed the Co-Trustee (or, if the Co-Trustee was named by more than one Trustee acting together, the last to serve of those Trustees), and the Co-Trustee shall not become a successor Trustee upon the death, resignation, or disability of the Trustee who appointed the Co-Trustee unless the Co-Trustee is elected as successor Trustee in accordance with paragraph E of this article. Any reference to a "Trustee" refers equally to any successor Trustee or Co-Trustee.

C. Any Trustee may, from time to time, delegate to any other Trustee by written instrument any or all of the Trustee's powers (except those, if any, not exercisable by the other Trustee). This delegation may be temporary or permanent, and if temporary, may be for any duration of time or until any event specified by the delegating

Trustee. Any person dealing in good faith with any Trustee may rely without inquiry on the Trustee's certificate with respect to any delegation.

D. No Trustee named in paragraph A, above, shall be required to provide surety or other security or a bond.

E. Any Trustee may resign by giving written notice, specifying the resignation's effective date, to each adult beneficiary of the current trust income, to a custodial parent of each minor beneficiary of current trust income, and to the legal guardian of any beneficiary of current trust income having a legal guardian, each determined at the time the notice is given. If none of the Trustees named above are able or willing to serve as Trustee of this trust, a corporation authorized to render trust services shall be named successor sole Trustee by majority vote of the then-income beneficiaries, with the adult beneficiaries voting on their own behalf, one vote being cast for each minor income beneficiary by the minor's custodial parent, and one vote being cast by the legal guardian of any beneficiary having a legal guardian. For purposes of this Article, the right to receive "support" from the trust is a right to current trust income. Notwithstanding the foregoing, in no event may either Grantor vote in the election of any successor Trustee.

F. No Trustee shall be required to obtain the order of any court to exercise any power or discretion under this trust.

G. No Trustee shall be required to file any accounting with any public official. The Trustee must, however, maintain accurate records concerning the trust. Each year, the Trustee shall furnish an annual accounting of the trust's condition, including receipts and disbursements, to each adult beneficiary of the current trust income, to a custodial parent of each minor beneficiary of current trust income, and to the legal guardian of any beneficiary of current trust income having a legal guardian, each determined at the time the notice is given. This required accounting may be satisfied by a copy of the trust's federal income tax return, if one is required.

H. Any corporate Trustee shall be entitled to compensation based on its published fee schedule in effect at the time its services are rendered.

I. A trust's sole income beneficiary may remove a corporate Trustee and appoint a successor corporate Trustee as long as the successor Trustee has no power that, if held by the income beneficiary personally, would be a general power of appointment for federal estate tax purposes. Multiple income beneficiaries may, by unanimous action, remove a corporate Trustee and appoint a successor corporate Trustee as long as the successor Trustee has no power that, if exercisable by such income beneficiaries unanimously, would be a general power of appointment for federal estate tax purposes. In applying these powers, the following rules apply:

   1. Whoever may remove a corporate Trustee may also appoint a successor corporate Trustee.

   2. A power to remove a corporate Trustee shall be exercised by a writing delivered to the then-serving corporate Trustee, indicating the removal's effective date, the name of the successor Trustee, and the successor Trustee's agreement to serve.

   3. The minor and/or unborn descendants of an individual who are themselves income beneficiaries shall vote on removal of a corporate Trustee through a legally appointed guardian, who may not be their ancestor who is also named as an income beneficiary.

4. Beneficiaries of successive income interests (other than those following a present lifetime income interest) will be treated as multiple income beneficiaries.

Article XIII
Exculpation of Trustee

Notwithstanding any rule of law, statute, or policy to the contrary, any Trustee serving as such in accordance with this trust agreement shall not be liable or responsible to any beneficiary of this trust under any of the following circumstances:

A. The Trustee shall not be liable or responsible to any beneficiary of this trust if any life insurance company insuring the life of either Grantor (or both Grantors) in accordance with a policy of life insurance either transferred to the Trustee by the Grantors or selected by the Grantors for purchase by the Trustee ceases to exist, becomes bankrupt, fails to remain solvent, or otherwise becomes unable to perform its obligations.

B. The Trustee shall not be liable to any beneficiary for any damages if any life insurance company insuring the life of either or both Grantors in accordance with a policy selected by the Grantors and obtained by the Trustee fails to make any payment to the Trustee in the event of either Grantor's death for any reason whatsoever (except the Trustee's failure to demand such payment from the insurance company within a reasonable time after the death of either Grantor).

C. The Trustee shall not be liable or responsible to any beneficiary of this trust if the assets of this trust are insufficient to make any premium payments due with respect to any life insurance policy insuring the life of either Grantor (or both Grantors) and owned by the trust, or if for any reason the Trustee is unable to convert any cash value or other assets of this trust to provide the Trustee with sufficient funds with which to pay the life insurance premiums.

D. The Trustee shall not be liable to either Grantor or any beneficiary of this trust if any sums contributed to this trust or any death proceeds paid to the Trustee because of either Grantor's death are taxable in either Grantor's estate for federal estate tax purposes, or if the gifts or transfers are taxable to either Grantor or any other person for federal gift tax purposes.

E. The Trustee shall not be liable or responsible to any beneficiary of this trust if any notice given by the Trustee with respect to the powers of withdrawal set forth above in Article III of this trust are deemed inadequate by the Internal Revenue Service, the Department of the Treasury, or any other competent governmental authority with the result that adverse income, estate, or gift tax consequences are suffered by either Grantor or any beneficiary of this trust.

F. The Trustee (and any employee of the Trustee) shall not be deemed to have given any advice to either Grantor or any beneficiary with respect to either Grantor's (or any beneficiary's) state or federal income tax consequences, state or federal estate tax consequences, state or federal gift tax consequences, or any state or federal excise tax consequences following from the creation of this trust or the transfer of any assets to or from this trust.

G. If the Trustee discharges the Trustee's responsibilities under this trust agreement in a conscientious and fiduciary manner, and as long as the Trustee discharges the Trustee's responsibilities hereunder as required by this agreement, the Trustee shall be relieved of liability to any beneficiary under this agreement (or to either Grantor) as a result of any unforeseen or unanticipated consequence, including the types of consequences described above in this Article.

Article XIV
Miscellaneous

A. This trust shall be governed by and construed according to the laws of Missouri.

B. Whenever the context of this trust requires, the singular number includes the plural, and vice versa.

C. The Grantors request (but do not require) that the Trustee employ the services of the Grantors' attorney, ________________, with respect to any legal issue that affects either Grantor's estate or this Trust.

In witness whereof, the Grantors and the Trustee have hereunto set their hands and seals to this trust agreement and declared that this trust became effective as of the _____ day of ________________, 20___.

____
John Doe (Grantor)

____
Jane Doe (Grantor)

____
Joe Smith (Trustee)

____
John Smith (Trustee)

State of Missouri)
) ss.
County of _______________)

On this _____ day of ________________, 20___, before me, a notary public in and for the county and state aforesaid, personally appeared John Doe and Jane Doe, husband and wife, known to me to be the persons who executed the foregoing Life Insurance Trust as "Grantors," and acknowledged to me that they executed the same as their free act and deed for the purposes therein stated.

____
Notary Public
Commissioned in _______________
County, _______________________

My commission expires ____________________.

State of Missouri)
) ss.
County of _______________)

On this _____ day of ________________, 20___, before me, a notary public in and for the county and state aforesaid, personally appeared Joe Smith, known to me to be the person who executed the foregoing Life Insurance Trust as "Trustee," and acknowledged to me that he executed the same as his free act and deed for the purposes therein stated.

____
Notary Public
Commissioned in _______________
County, _______________________

My commission expires ____________________.

State of Missouri)
) ss.
County of ________________)

On this _____ day of ________________, 20___, before me, a notary public in and for the county and state aforesaid, personally appeared John Smith, known to me to be the person who executed the foregoing Life Insurance Trust as "Trustee," and acknowledged to me that he executed the same as his free act and deed for the purposes therein stated.

____
Notary Public
Commissioned in _______________
County, _______________________

My commission expires ____________________.

Schedule A

This Schedule A is included only for the convenience of the Trustee and beneficiaries, and any failure to list trust assets on Schedule A will in no way alter the trust's ownership of those assets.

$10.00 Cash

____________ Life Insurance Company, Policy No. ____________, dated ________________, insuring the life of John Doe and Jane Doe in the amount of $1 million ("second-to-die" policy)

B. (§12.71) Letter to Clients

Letter to Clients

Mr. and Mrs. John Doe
1234 Broadway
Columbia, Missouri 65201

Re: Specifications and Considerations Involved in Purchasing New Life Insurance Policies for Your Estate Planning

Dear Mr. and Mrs. Doe:

This letter is intended to help you formulate your estate plan and to help you decide among competing insurance agents and life insurance policies. Before you purchase a new life insurance policy, you should understand a few important concepts. Please note the following:

1. ***Types of Insurance*:** There are as many different provisions in life insurance contracts as there are insurance companies. For this reason, it is easy to compare "apples to oranges" by mistake and thus not know if you are getting the most favorable policy. Because no two companies' policies are identical, deciding which is the better bargain is difficult. But the following concepts are important in your planning:

    a. The primary purpose of insurance is to provide liquidity and to replace or create wealth. Insurance is a gamble, that is, the insurance company gambles that you will live a long time and pay all of your premiums in a timely manner; when you purchase a policy, perhaps you are gambling that you are going to die in the relatively near future and, thus, your beneficiaries will receive more in death benefit proceeds than you will have paid out in premiums. Usually, the insurance companies win the bet and, hence, remain profitable.

b. You have two basic needs in obtaining life insurance at this stage:

    (1) Provide some liquidity with which to pay federal estate taxes that would be payable if you die; and/or

    (2) Provide liquidity and additional funds for living expenses in the event of the breadwinner's death, because his or her salary would cease at death.

c. There are two basic types of insurance:

    (1) Term life insurance or "pure" insurance

    (2) Whole life or "ordinary" life insurance

Ordinary life insurance has a "savings" aspect in that you pay a lesser premium than would be due for a term policy at your respective ages. Term insurance is "pure" in the sense that the premium represents the pure actuarial risk of insuring your life as far as the life insurance company is concerned, plus an amount necessary to pay the life insurance agent the commission involved in selling the policy and make a small profit for the company. A term policy does not build up any cash value. Furthermore, the typical term life insurance policy eventually becomes prohibitively expensive as the age of the insured rises because of the statistical probability of the insured's death within an increasingly short period of time. While a term life insurance policy may be cheap for a 25-year-old, it is expensive and perhaps almost impossible to obtain term life insurance on an 80-year-old individual.

d. Because the cost of insurance rises over time, insurance companies have developed programs whereby the savings portion of a premium is invested and eventually "pays up" the policy. In other words, the insurance company's earnings from the additional cash deposited with it over the life of the policy permit it to continue to provide life insurance to the individual insured after the owner of the policy stops paying premiums. The insurance company plans these policies so that the earnings from the investment of the excess premium dollars permits the company to refund (in effect) some of those premium dollars to the insured at death while still permitting the insurance company to make a profit.

e. Some insurance companies do a better job of investing their funds than others. Some insurance companies have enjoyed better management over the term of their existence than others. Some of these insurance companies allow their policyholders to "participate" in these profits, and the policy dividends thus have the effect of reducing the cost of these policies over time.

f. As I see it, you need at least two different insurance policies to accomplish the estate planning goals we have discussed over the past several months. The first life policy you may need is a policy designed to replace wealth or provide estate liquidity if you and your spouse both die. You will recall that the federal estate tax provides for an unlimited marital deduction. Thus, gifts between spouses are not taxed. This means that there would not be any significant estate taxes due on the death of the first spouse; rather, only on the death of the second spouse would any significant amount of estate tax be due. Thus, any life insurance policy purchased with a view toward providing liquidity to pay estate taxes would be important only upon the death of the second spouse to die. It is possible to purchase this type of life insurance (a "second-to-die" policy).

g. Second-to-die policies can be term policies or whole life policies. Thus, you have to make the same type of decisions on a second-to-die policy as you would on a policy insuring just the life of one of you. Perhaps the best way to make this decision is to decide whether your need for this insurance is "permanent" or "temporary." If you decide that your need is only temporary, a term policy will suffice. On the other hand, if you foresee that the need for this insurance will exist for as long as you have children who are dependent on you or for as long as you have to worry about funding a federal estate tax liability, a whole life type policy may be the best investment.

h. You will quickly learn that the premiums for a permanent (whole life) policy will be about seven times the premiums for a term insurance policy for the same amount of death benefit at your present ages. As time goes on, however, either the amount of term insurance available to you will decrease or the premium payable to maintain a specified amount of term insurance coverage will increase (or both). A whole life or permanent insurance policy, however, does not have this problem. Once the premium has been established, it remains fixed until the policy is paid up. Indeed, a whole life policy should build up cash value as time goes on more rapidly than just the amount of the "savings" feature built into the premium if it is a "participating" policy or one that permits these "excess" premiums to be invested in mutual funds (such as a "variable life policy").

i. Over a period of years, the cheapest insurance to purchase on a permanent basis is a policy that requires premium payments for about 10 years and then has enough of a cash value that the dividends or earnings payable with respect to the policy are sufficient to pay the premiums due from then on.

j. The problem with evaluating or comparing one policy of life insurance to another is not merely comparing whether it is a term policy or a whole life policy, but determining the cost of various "bells and whistles." For example, with a second-to-die policy, it might be desirable to have a waiver-of-premium "rider" (endorsement) so that on the death of the first spouse, the second spouse does not need to make any further premium payments to keep the policy in effect. Obviously, there would be nothing free about this benefit—you would have to pay for it. But if that particular feature were part of the quote given to you by an insurance agent and another competitor's policy did not have this feature, comparing the two might give you a distorted view as to the true cost of each policy.

k. Similar optional policy endorsements that insurance companies frequently offer are:

- options that involve a guaranteed convertibility of a term policy into a permanent policy;
- a guaranteed right to acquire additional insurance as time goes by without obtaining a new physical examination; and
- an automatic "cost-of-living increase" rider that automatically increases the amount of insurance involved, etc.

Each of these additional features adds cost to a policy. It is difficult, but not impossible, to get an insurance agent to quantify the costs of each of these features so that you can make a true comparison of the cost of two competing policies. If one company refuses to sell a particular type of insurance policy rider or refuses to sell a particular insurance product without deleting some additional "special features" and you want to compare that policy to another company's product, you must make certain that all of the features are substantially identical.

l. Obviously, you do not want to purchase any more insurance than you can afford. Although term insurance is cheaper in the short run, it is more expensive in the long run. If you plan on terminating a term insurance policy in fifteen or twenty years, however, it is usually possible to find a term product that will involve a level premium over that period of time, and you would just have to remember that, at the expiration of the time period involved, you will not have the expired policy's insurance protection any longer.

m. As a general rule, a married couple's need for life insurance declines with time as their debts are paid, their financial obligations to their children are discharged, and their needs to consume decline. But in your situation, if the federal estate tax potentially payable by your estates is not addressed through proper planning, life insurance payable upon the death of the second spouse may be a continuing need to prevent the problem that otherwise will be caused to your descendants, who might otherwise have to sell assets to generate the funds required to pay the taxes due. Estate planning that involves substantial gifts over a period of time and other techniques may lessen the need for this life insurance. Life insurance on the spouse who is the "breadwinner" may not be necessary after he or she retires if there is an adequate retirement program in effect that will continue after the breadwinner's death. In this event, life insurance on the breadwinner's life alone might not be necessary after a period of years; thus, some married couples conclude that, while the second-to-die life insurance policy needs to be permanent insurance, the life insurance on the breadwinner's life alone can be term insurance.

n. A final word about permanent or whole life insurance may be in order. Whole life is a form of forced savings. The typical married couple will meet a financial obligation, and once having signed up to pay a substantial life insurance premium over a ten-year period of time, they will pay the premium and usually are pleased to find at the end of a ten- or fifteen-year period that they have accumulated and will continue to accumulate an increasing cash value build up inside of a whole life insurance policy that, under current tax law, is income tax free until collected. If a policy is cashed in, taxes will have to be paid on the gain produced by surrendering the policy for cash, but if the policy is never surrendered, the tax-free buildup remains immune from state and federal income taxation. This same couple might have had difficulty saving this same amount if there was no obligation to do so. Of course, this asset may still be subject to estate taxation, depending on many other factors that we need to discuss in the future.

2. ***Insurance Required for "Family Estate Planning."*** The primary purpose for the proposed "second-to-die" life insurance that you will purchase will be to fund the estate tax liability that might arise if something

happens to the two of you in the near future. Furthermore, because the income from your family investments may not be adequate to replace the salary and other benefits that are presently being paid to ______________, a life insurance policy on ______________'s life might be a good idea. This would permit ______________, as surviving spouse, to be assured of income and support following ________________'s death. Furthermore, there might be needs that your children would have in addition to merely paying estate taxes from life insurance proceeds. In other words, a policy just on ________________'s life might be necessary from the children's perspective also, at least for several more years. Thus, it seems to me that you should price and obtain a life insurance policy on ________________'s life and a second-to-die policy on both of your lives at a minimum. The amount of this insurance is discretionary. But it seems to me that each of these policies should be at least $500,000, and I suspect that if the face value of each of these policies were $1,000,000, it would not be too much insurance under the circumstances.

3. ***Estate Tax Considerations***: The problem with life insurance is that the full amount of the death proceeds is taxable for federal estate tax purposes in the estate of the insured if the insured owns any of the "incidents of ownership" with respect to the policy. This means that, if the insured has the right to change the beneficiaries of the policy or to surrender it for cash or otherwise modify the important terms of the policy, the amount of the insurance payable upon the insured's death will add to the insured's estate's potential estate tax liability. For this reason:

   a. I believe you should establish an irrevocable life insurance trust to own any second-to-die policy on your joint lives. This would mean that, regardless of the order of deaths, at the time the life insurance is paid on the death of the second spouse, the amount of the insurance proceeds paid would not be included in your estate for estate tax purposes, and your children would be able to receive the proceeds from this second-to-die policy estate tax free.

b. Any life insurance policy insuring the life of just ________________________ should be owned by ________________________, and vice versa. If ________________ dies first, her estate planning documents can transfer ownership of any policy on ________________'s life to a trust for your children or outright to your children. Then upon ________________'s death, the value of the life insurance on ________________'s life that is the subject of a policy then owned by the children or a trust for the children would not be included in ________________'s estate for estate tax purposes under current estate tax laws. I do not believe that husband should own any life insurance policy on ________________'s life.

c. If a separate life insurance policy is obtained on ________________'s life, the primary beneficiary of this policy should be ________________ during her lifetime. This would help assure ________________ a comfortable living after ________________'s death and until her death. Again, if ________________ dies first, this benefit can be transferred to the children as a part of ________________'s estate without it becoming ________________'s asset. Of course, this would have to be taken care of in estate planning documents that the two of you must prepare and execute in the future.

d. The irrevocable life insurance trust that owns the second-to-die policy on the two of you cannot be trusteed by the two of you. But perhaps one or more of your siblings can be the co-trustees of this trust. The beneficiaries of this second-to-die insurance trust would be your children. The funds in this trust can be loaned to a fiduciary for use in paying a liability that otherwise would exist if something happens to the two of you (e.g., to pay estate taxes) and can be used to support your children to the extent that the insurance proceeds are not necessary for the payment of estate taxes.

e. Life insurance that is owned by an insured and then transferred by gift to some other owner nevertheless is included in the insured's estate for estate tax purposes if the insured dies within three years of the date of the transfer of the policy. But life insurance that is *originally procured* by someone other than the insured is not included in the insured's estate on the insured's death if the insured never had any of the "incidents of ownership" referred to above. For this reason, any new life insurance policy on ________________'s life alone should be applied for by ________________ as the original owner of the policy, and vice versa. Any life insurance policy to be issued on your joint lives (the second-to-die policy) should be applied for in the name of the trustee of the new insurance trust discussed above, with the original owner and beneficiary of the second-to-die policy being the trustee of this new insurance trust.

4. ***Criteria for Evaluating Life Insurance Policies*:** I have attached to this letter a suggested letter that you might wish to submit to insurance agents with whom you are dealing, asking for quotes/bids on life insurance for the foregoing purposes. If any insurance agent with whom you are dealing does not believe that any of the criteria in the attached letter is sufficiently clear or overlooks some important aspect of life insurance products potentially available, please let me know. Otherwise, I hope that the foregoing information and the attached suggested letter satisfy your needs at this point. Once you have settled on the amount and company from

whom you will purchase your insurance, we can complete the rest of your estate planning.

5. ***Irrevocable Insurance Trust***: The trust to own the above-referenced second-to-die policy would be irrevocable and would be created so that any life insurance payable as a result of your death will not be included in your estate for federal estate tax purposes. This will occur only if the trust's separate identity is respected and the formalities hereafter described are observed.

6. ***Premium Payment Procedures***: This trust should have its own separate bank account. The only persons authorized to sign checks on this bank account should be the trustees of the trust. If there is more than one trustee, the co-trustees can establish these accounts so that any one trustee (without the consent of the other) may draw a check on the account. Alternatively, they can establish it so that it takes *all* trustees' signatures to draw a check on the account. Any gift you make to the trust should be given to the trustees, and the trustees should deposit the gift in the trust's bank account. Thereafter, the trustees should use the funds in the bank account to pay any life insurance premiums on policies owned by the trust. You should *not* pay any of these premiums directly.

7. ***Crummey Powers***: A gift to a trust is a gift of a "future interest." A beneficiary of a trust typically does not have the current right to enjoy the trust income/principal. This would apply to your insurance trust because it would be created to provide benefits in the future. Thus, gifts to your trust would not qualify as gifts of "present interests" unless certain provisions, which are commonly known as "Crummey powers," are included in the trust document. In this regard:

    a. A gift of a future interest does not qualify for the annual gift tax exclusion. (Currently, in 2009, this exclusion is $13,000 per donee; this amount will increase in future years.) But a gift of a present interest does qualify for the annual gift tax exclusion. We want any gift to your trust to qualify as a gift of a present interest.

b. To help ensure this, I will include in your insurance trust agreement a provision that certain named persons have the right to withdraw their proportionate share of any gifts made to the trust for a period of 60 days after the date any gift is made. The trustees would be required to notify these various beneficiaries of these rights, and then the beneficiaries, if they do not exercise these rights, are deemed to have abandoned these rights for the future. These immediate withdrawal rights are referred to as "Crummey Powers," based on a United States Tax Court case known as *Crummey v. Commissioner of Internal Revenue*, which first established the validity of this technique.

c. To help ensure that we will receive "present interest" treatment of the gifts you make to your trust, "Crummey Notices" to the Crummey beneficiaries need to be given each year. My office will take care of this if you will tell us when and in what amount you are making gifts to your trust.

8. ***Nondeductible Nature of Gifts/Payments***: The gifts you make to the trust will be from your after-tax personal income. No income tax deduction is available to you for gifts made to this trust. You should not have anyone at your business make these premium payments from a business account because it should not be confused with or commingled with other employee benefit life insurance programs or your wages. Instead, you should follow the procedures set forth above.

9. ***Timing of Contributions to Trust*:** As noted above, a gift to the trust would be a gift of a "future interest" but for the fact that the trust has granted certain "Crummey powers" to certain named beneficiaries (e.g., your children). In other words, if your children want to do so, they can pull out the deposit you just made to the trust. Of course, this would not leave any money in the trust for the payment of insurance premiums; thus, presumably, your children will not be short sighted and will let the money stay in the trust so it can be used to pay the insurance premium on your life insurance trust. But the money needs to be deposited into the bank in time for the trustees to give notice to the Crummey beneficiaries that a deposit was made to the trust so that they have the right to withdraw it under the provisions of your trust agreement, which authorize this withdrawal. This right of immediate withdrawal is the "Crummey power" referred to above. The existence of the "Crummey powers" makes the gift to the trust each year a gift of a "present interest" instead of being a gift of a "future interest." This makes the gift eligible for the annual gift tax exclusion. You and your spouse together, therefore, can give $26,000 per child per year without incurring a liability for gift tax. (This amount will increase in future years.) But your gifts of cash to the trustee must occur in enough time for the trustees to notify the Crummey beneficiaries of their powers, let the time for withdrawal of the cash involved expire, and use the cash in the account to pay the premiums due on the policy. This means that there will be some farsightedness required, i.e., you will have to deposit the money with the trustees early enough for them to give the notice, let the time run, and pay the premium to the insurance company on or before this date.

10. ***Bank Account for Irrevocable Trust*:** The bank account referred to above, which pertains to your trust, should be established by the trustees for the trust when it is first created. All gifts by you to the trustees should be deposited *by the trustees* into this bank account. You should not directly deposit these sums into the bank

account, and you should not make payments of the life insurance premiums directly.

If you have any questions, please let me know.

____
Signature

Suggested Letter

[Date]

[Insurance Agent]

____

____

Re: Request for quotation/bid on life insurance policies

Dear [Name of Agent]:

We are considering acquiring life insurance for estate planning purposes. Specifically, we are interested in acquiring two separate policies of life insurance on our lives that will have the characteristics described below. We have submitted this letter to several insurance agents so that we can determine which life insurance company offers us the most value for our premium dollar. Please prepare a quotation that is consistent with the following information, and if further information is necessary, please let us know. The life insurance policies that we desire to acquire at this time are:

1. **"Second-to-Die" Life Insurance Policy to be Owned by Irrevocable Life Insurance Trust:** We intend to establish an irrevocable life insurance trust in the near future. The trustees of this trust will be ________________. The principal asset of this trust will be a life insurance policy insuring our joint lives and will be in the form of a "second-to-die" policy that will pay upon the death of the last to die of the two of us. The amount of life insurance protection we desire to procure in this regard is $________________. In addition, we desire that this policy have a waiver-of-premium rider such that, upon the death of husband (if he is the **first** to die), no further premiums will be due with respect to this policy during the remaining lifetime of wife. Furthermore:

    a. We desire that this policy be a "permanent" policy and that it be fully paid up over a period of ten years so that after we pay approximately ten years of premiums, no further payments will be due with respect to this policy, assuming the same rate of earnings and policy growth as your company has experienced over the past ten years.

b. The beneficiary and owner of this policy will be the trustees of the irrevocable insurance trust described above. We want the applicant for this policy to be shown as the trustees of the insurance trust as well.

c. Although we may not purchase this option, we would like to have separately priced some type of inflation protection or additional insurance option so that if the trustees of the trust decide to add additional insurance coverage on this policy over time, it would be possible to do so without the necessity for us to qualify by taking a new physical examination.

2. **Term Life Insurance Policy Insuring Life of Husband:** The second policy we are interested in obtaining is a life insurance policy that will be owned and applied for by wife, that will have wife as its current beneficiary, and that will insure the life of husband in the amount of $________________. We are interested in pricing a term insurance policy that will insure the life of husband for a period of 20 years and that will require a level premium during that 20-year period. Furthermore:

   a. We are interested in pricing a convertibility option as a separate matter, i.e., the option to convert this term policy to a permanent or whole life insurance policy at any time during the existence of the term contract without the need for husband to take another physical examination.

b. We are interested in pricing a rider with respect to this policy that would automatically pay the insurance premium in the event of the permanent total disability of husband.

c. We are interested in pricing an option or rider with respect to this policy that would permit it to continue past its 20-year policy period at a premium amount that will be applicable at that time without the need for husband to submit to a physical exam and that specifies now the new premium payable if this option is selected.

3. **NAIC Model:** The illustrations of insurance coverage you provide should be submitted using the NAIC (National Association of Insurance Commissioner) Life Insurance Illustration Model.

4. **Conclusion:** Please try to submit a proposal consistent with the foregoing requests. Each cost component of these requested policies should be specified, and if there are other features or riders to these policies that you believe we might want to consider, please furnish us with information concerning them and separately state the cost of each.

Thank you for your attention to this, and if you need further information, please let us know.

____

[Signatures]