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ACCELERATED DEATH BENEFIT

An accelerated death benefit (ADB) is a portion of a life insurance death benefit that is paid to the insured after he has been diagnosed as either chronically or terminally ill. Provided certain conditions are met, payments received may be excluded from federal taxable income.

A person is considered *terminally* ill if certified by a physician to have an illness or physical condition that is reasonably expected to result in death within 24 months. A person is considered *chronically* ill if certified by a health care professional as unable to perform for a period of at least 90 days, without substantial assistance, at least two activities of daily living (i.e., eating, toileting, transferring, bathing, dressing, and continence) or requires substantial supervision to protect himself from threats to health and safety due to severe cognitive impairment (i.e., a deterioration or loss of intellectual capacity that places the individual in jeopardy of harming self or others). These standards for the chronically ill also apply to long-term care benefits (see chart, page 261).

There is no limitation on the amount or use of payments made to a *terminally* ill person. However, payments made to a *chronically* ill individual generally must be for the actual costs incurred that have not been compensated for by insurance or otherwise. The tax treatment will depend on the Tax Code section the policy was filed under. Amounts received from a qualified long-term care contract in 2015 are generally not includable in income up to the greater of $330 per day or actual costs incurred (see discussion on page 517). The terms of the contract must comply with certain provisions of the Internal Revenue Code, standards adopted by the National Association of Insurance Commissioners (NAIC) and standards adopted by the state in which the policyowner resides. These are the same limits and requirements that apply to payments for long-term care (see chart, page 261).

In contrast to an accelerated death benefit *received* under a life insurance policy, when a chronically or terminally ill insured *sells* his death benefit at a discount to a third party it is known as a life settlement or viatical settlement (see discussion, pages 462-463).

ACCOUNTING FOR BUSINESS LIFE INSURANCE

Premium Payments. With cash value insurance the excess of net premiums paid (i.e., the premiums paid less dividends declared, if any) over the increase in cash surrender values is considered an insurance expense. Because premium payments are generally *not* deductible as a business expense, they are usually considered an "Extraordinary Item" and placed on the profit and loss statement before "Net Income Before Taxes," as at **B** on page 331. Alternatively, the insurance expense could be shown on the balance sheet as a direct charge to capital, with no entry being made on the profit and loss statement (note that this method highlights the non-tax-deductible nature of the expense).

Cash Values. The general rule is that cash values are carried on the balance sheet under "Noncurrent Assets," as at **A** on page 331 ("noncurrent assets" are also referred to as "other assets"). It has been suggested that with universal life containing surrender charges the full cash values should be carried as an asset. However, this is not consistent with the position taken by the Financial Accounting Standards Board in FASB Technical Bulletin No. 85-4, entitled "Accounting for Purchases of Life Insurance." When responding to the question of how to account for an investment in life insurance, the bulletin states: "*The amount that could be realized* under the insurance contract *as of the date of the statement* of financial position should be reported as an asset …. the current capacity to realize contract benefits is limited to settlement amounts specified in the contract" [emphasis added]. When it is intended to surrender a universal life policy value during the normal operating cycle, the *surrender* values might be carried on the balance sheet as a "Current Asset," as opposed to a "Noncurrent Asset."

Policy Loans. Usually there is no intention of repaying the policy loan within the current year, in which case the loan should be reflected on the balance sheet as a deduction from the cash surrender value (i.e., net cash surrender values should be shown). If there is an intention to repay within the current year, the loan should be carried as a current liability and the full cash surrender value shown as an asset.

Death Benefits. The amount of the death benefit in excess of the cash surrender values is considered a gain to corporate surplus. The entry can be made as a negative expense under Extraordinary Items on the profit and loss statement (**B** on page 331). Assuming cash surrender values of $36,000 and a death benefit of $250,000, the actual entry would read, "Plus: proceeds of officers life insurance in excess of cash surrender value … 214,000."

(continued on next page)

ACCOUNTING FOR BUSINESS LIFE INSURANCE (continued)

BALANCE SHEET

ASSETS			
CURRENT ASSETS:			
Cash	$450,000		
Notes and accounts receivable	850,000		
FIXED ASSETS:			
Land	300,000		
Buildings	550,000		
Machinery and equipment	220,000		
NONCURRENT ASSETS:			
Prepaid insurance, taxes, etc.	18,500		
Life insurance cash surrender values	36,000 **A**		
Total Assets			$2,424,500
LIABILITIES AND STOCKHOLDER EQUITY			
CURRENT LIABILITIES:			
Notes and loans payable banks	$145,000		
Accounts payable	85,000		
Liability for income taxes	42,500		
LONG-TERM LIABILITIES:			
Mortgages	735,000		
Total Liabilities		$1,007,500	
STOCKHOLDER EQUITY:			
Common stock authorized and issued	$900,000		
Retained earnings	517,000	1,417,000	
Total Stockholder Equity			
Total Liabilities and Stockholder Equity			$2,424,500

PROFIT AND LOSS STATEMENT

Net Sales		$ 869,000	
Less: Cost of Sales and Operating Expenses			
Cost of goods sold	$260,000		
Depreciation	95,000		
Selling and administrating expenses	184,000		
		(539,000)	
Operating Profit			$ 330,000
Other Income			
Interest and dividends			5,000
Total Income			$ 335,000
Extraordinary Item			
Less: life insurance expense			(7,000)**B**
Net Income Before Taxes			$ 328,000
Provision for Income Tax			(113,900)
Net Profit for Year			$ 214,100

ACCUMULATED EARNINGS TAX

Accumulating corporate earnings and profits in excess of the reasonable needs of the business and for the purpose of avoiding income tax can in 2015 result in a surtax of 20 percent of accumulated taxable income (as increased from 15 percent by the American Taxpayer Relief Act of 2012). This surtax is imposed on the current year's earnings, and once taxed, accumulated earnings are not again taxed in subsequent years during which the accumulation is retained.

However, a corporation is allowed to accumulate at least $250,000 without being subject to this surtax. This figure is reduced to $150,000 for personal service corporations, whose principal business consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Reasonable needs of the business can include: (1) providing for plant expansion; (2) acquiring another business through purchase of either stock or assets; (3) retiring indebtedness; and (4) making loans to suppliers or customers in order to maintain the business of the corporation. Insurance carried as *key person insurance*, or to help meet an employer's obligation under a *deferred compensation plan* or *entity purchase agreement (§302)*, is generally considered as carried for reasonable business needs. However, under Section 303 (partial stock redemption) only accruals in the year of death or thereafter are considered as carried for reasonable needs of the business.

For example, if a corporation in its first year of existence in 2015 has $425,000 of retained earnings for which no reasonable need exists, it would be subject to a penalty tax of $35,000. It is calculated as follows:

First	$250,000	is exempt from tax
Excess	$175,000	is subject in 2015 to a tax of 20 percent, or $35,000

The penalty tax is imposed *in addition to* the regular corporate income tax.

AGE-WEIGHTED PROFIT SHARING PLAN

Pension plans, both defined contribution (money purchase and target benefit) and defined benefit, require that the employer make recurring annual contributions. These annual obligations can be avoided with profit sharing plans. Under a traditional profit sharing plan employer contributions are generally allocated each year to employees in proportion to relative compensation, either with or without Social Security integration. However, with an age-weighted profit sharing plan the participant's age is taken into account when making these allocations. The results are similar to those produced in target plans, with significantly larger allocations (as a percentage of compensation) to older employees, but with the added flexibility of a profit sharing plan (e.g., fixed annual contributions are required under a target plan, but there is no such requirement under an age-weighted profit sharing plan).

One of the most common types of age-weighted profit sharing plans is the "cross tested" or "new comparability" plan. The name is derived from the cross testing that is used in order to satisfy the nondiscrimination regulations. An age-weighted plan that discriminates as to contributions may be permissible, provided it does not discriminate when compared to benefits that could be provided using the benefits testing. With respect to defined contribution plans, cross testing is an "end justifies the means" or "benefit justifies the contribution" test. It is permissible for a profit sharing plan to fail the nondiscrimination tests for defined contribution plans, provided it actually produces nondiscriminatory benefits using the nondiscrimination tests applicable to defined benefit plans. Final regulations define three methods under which a cross tested defined contribution plan can satisfy the nondiscrimination in amount requirement.

To summarize, compared to defined benefit plans and other pension plans (both money purchase and target benefit), profit sharing plans offer the flexibility of not having to make annual contributions, but age-weighted profit sharing plans offer the additional advantage of providing significantly larger allocations to older employees.

See also, the discussion of qualified retirement plans on page 519.

ANNUAL EXCLUSION GIFTS

Individuals have the ability to make annual gifts, each year, up to certain indexed amounts without these gifts eroding into one's other gift options, such as one's lifetime exemption. For 2015 the annual exclusion gift amount is $14,000. These annual gifts can be made from an individual (the donor) to any number of individuals (the donee). For example, a parent with 2 children can make annual exclusion gifts to each of the children totaling $28,000, or $14,000 each year.

To qualify for the annual exemption, a gift must be of a current rather than a future interest. This means the gifts must be unrestricted and not contingent on the occurrence of an event or the performance of certain duties or tasks.

Additionally, spouses may be able to expand on this dollar amount. Where a spouse consents, they can gift their annual exclusion amount through a concept known as gift-splitting. Using the example in the first paragraph a married couple is able to gift up to $56,000 to their two children. So long as the spouse consents to use their own annual exclusion amount the larger gift is allowed even if the transferred funds all come from one spouse's assets. Gift limits are indexed annually.

An annual exclusion gift does not need to be reported on a gift tax form (Form 706), but reporting on such a form has the advantage of beginning the statute of limitations in the event the IRS might question the valuation of a gift. For split gifts, spouses should file a Form 706 so as to document the consent of the spouse allowing the split gift.

When gifting to a trust, care must be taken in drafting to ensure trust assets are not included in the estate, and certain withdrawal powers generally have to be provided to qualify the gifts for the annual exclusion. These withdrawal powers are often referred to as Crummey Powers or Crummey Notices. See page 368.

The complexity of gifts to trusts aside, annual exclusion gifts offer a tremendous opportunity to use life insurance to provide for a client's beneficiaries. In the example at the start of this segment, a couple was able to currently gift up to $56,000 per year into a trust. That amount could be used to purchase life insurance and, effectively, leverage the gift through the death benefit. When combined with a client's lifetime exemption the amount of life insurance that might be purchased can be significant. For example, from 2014 to 2015 the lifetime exemption amount was increased (due to indexing) by $90,000. For a couple that increase is a combined amount of $180,000. With the annual exclusion gifts added to that amount the couple in the example for this segment could gift $236,000 without any gift tax consequences. Moreover, assuming regular indexing for the lifetime exemption it may be possible for a couple to make a similar gift in later years.

Finally, in the case of gifts related to medical and education donors are allowed larger amounts than the $14,000 annual exclusion. Gifts can be made by donors directly to health care providers and educational institutions on behalf of individuals up to $50,000/year without triggering gift tax consequences.

ASSET PROTECTION

The term "asset protection" refers to techniques that offer protection from the claims of personal and business creditors.

These techniques can range from the simple to the complex. For example, in some states, much, if not all, of a personal residence is protected from creditors. Many states exempt annuity values, substantial life insurance cash values, and all death benefits. The assets of most retirement plans covered by ERISA are also protected (but not from tax deficiency claims or divorce disputes). The Supreme Court has strengthened IRA protection, and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides increased protection for most retirement plan assets. However, in light of the Supreme Court decision in *Clark, et ux v. Rameker*, 573 U.S. __ (2014), IRAs inherited by non-spouses may not necessarily have the same protection. That decision disallowed retirement plan status of inherited IRAs. Prior to the *Clark* decision spouses could receive special protection; however, in light of the *Clark* decision that protection may not continue. It is important to also look to state law as a number of states have either passed laws or had favorable court decisions that specifically protect inherited IRAs under state bankruptcy exemptions for federal bankruptcy purposes.

Gifts can be made to family members or charitable organizations; provided they are not made with intent to defraud creditors (see charts on pages 47 and 55). Gifts may also be made to an irrevocable trust or custodial account (see charts on pages 51 and 67, and discussions on pages 575-576 and 580).

More complex techniques include limited liability companies and family limited partnerships (see chart on page 171, and discussions on page 473 and pages 493-494). Trusts can be established with "spendthrift" provisions to prevent the creditors of trust beneficiaries from reaching trust assets (see discussion of self-settled trusts on page 552). But this technique does not provide protection from existing creditors.

The most sophisticated of all asset protection techniques is probably the offshore or asset protection trust (APT). See discussion of Self-Settled Trust on page 552. It is thought that using an APT to remove assets to a foreign jurisdiction will lead to more favorable terms in disputes with creditors. Just as some states have laws that are more favorable to asset protection; certain countries have gained similar reputations. Jurisdictions considered most favorable as a situs for APTs do not recognize foreign judgments (thereby forcing a retrial of claims), have weakened or no fraudulent conveyance laws, and permit a trust settlor to retain trust powers and benefits without subjecting the trust to the claims of creditors. APTs are not intended to avoid income taxes.

In our litigious society, it is understandable why monied individuals and high-risk professionals have long been interested in adopting asset protection techniques. However, a few words of caution: not only will the concealment of assets from a known creditor be set aside by the courts, but assisting a debtor will likely subject both the debtor and his advisor to ethical, civil, and criminal liability (e.g., Code section 7206, see page 496). Therefore, asset protection planning must begin long before there is a need. Also, state laws vary widely in the protection they offer and should be specifically consulted.

BANK OWNED LIFE INSURANCE (BOLI)

In many respects, Bank Owned Life Insurance (BOLI) is similar to Company Owned Life Insurance (COLI), in that BOLI enables banks to recover, or to informally fund, the costs of non-qualified benefit plans (see page 357). However, there are important differences.

Banks are considered highly "balance sheet sensitive." From a bank investment perspective, the life insurance contract has been described as "a perpetual municipal with a yield that resets to the market." From a bank accounting perspective, the purchase of life insurance has been described as a "repositioning" of assets on the balance sheet, "from the securities portfolio to the BOLI portfolio," that generates "incremental income." Unlike traditional taxable investments, the cash value increases of BOLI are reflected on the balance sheet as "other non-interest income," without any reduction for income taxes (accounting for BOLI policies is subject to FASB Technical Bulletin 85-5, see page 330). When compared to currently taxed investments, BOLI can produce improved after-tax yields and a positive impact on earnings per share.

Unlike COLI, the purchase of BOLI by national banks is very tightly regulated by the Office of Comptroller of the Currency (OCC) (FDIC regulated state-chartered banks are typically subject to similar regulation). When purchasing BOLI, OCC Bulletin 2000-23 requires an informed decision "consistent with safe and sound banking practices." To that end, the bank must perform a *pre-purchase analysis* that includes determination of need, quantification of amount, vendor and carrier selection, review of insurance product characteristics, determination of reasonableness of compensation, analysis of benefits and risks, and alternatives. The purchase of BOLI, "… must address a legitimate need of the bank for life insurance. Life insurance may not be purchased to generate funds for the bank's normal operating expenses [or for] speculation …" However, the purchase of "key-person insurance, insurance on borrowers, insurance purchased in connection with employee compensation and benefit plans, and insurance taken as security for loans," are all found to fall within the "incidental powers [that are] necessary to carry on the business of banking."

BOLI policies are typically issued as either annual or single premium contracts. If purchased with a single premium, a BOLI policy is classified as a modified endowment contract (MEC), with the resulting LIFO taxation of policy withdrawals, loans and surrenders; and application of a 10-percent-penalty tax on amounts includable in gross income (see Life Insurance Premium Limitations, page 438). However, if the contract is held until the insured's death, the policy proceeds are received income tax-free (provided strict notice and consent requirements are met, see pages 357-359 and there is no prior "transfer-for-value," see page 573). Banks may purchase variable life insurance, provided it is for the purpose of "hedging their obligations under employee compensation and benefit plans." In selecting the employees to be insured, a bank must be mindful of the state "insurable interest" requirements (see discussion, page 426).

BOOK VALUE

Many approaches to valuation require a consideration of book value. Simply stated, book value is assets less liabilities, or the net worth of the business. However, because assets are often carried at substantially *below* their fair market value, care must be taken to assure that book value is adjusted upward to reflect accurately the value of these underlying assets. This adjustment in book value results in an *adjusted book value*.

For example, land purchased many years ago is likely to have appreciated in value, yet it is often carried on the books at the original purchase price. Machinery and equipment may be depreciated for income tax purposes, yet be worth substantially more than is shown on the books (when carried at its depreciated value). If the LIFO (last in, first out) method of inventory valuation is used, the value of inventory will likely be carried at below market value. This can be seen in the following example:

1000 units purchased at $1.00 on June 1	$1,000
1000 units purchased at $1.50 on July 1	1,500
1000 units purchased at $2.00 on August 1	2,000
Total cost of inventory	$4,500
Less 1000 units sold on August 2 (charged to inventory at $2.00 per unit)	(2,000)
Remaining 2,000 units carried at	$2,500
But to replace these units it would cost	$4,000
Inventory is undervalued by	$1,500

BUSINESS OVERHEAD EXPENSE INSURANCE

Business overhead expense insurance is designed to provide funds to cover overhead expenses during a business owner's disability. Business overhead expense insurance is intended to help maintain the business; it is not intended to replace disability income insurance (see chart, page 249) or disability buy-out insurance (see discussion, page 377).

Covered expenses include those that are tax deductible to the business. Typically these expenses include employee salaries, utilities, professional fees, rent, mortgage payments, lease payments for furniture and equipment, premiums for health, property and liability insurance, laundry services, janitorial services, and maintenance services. Not included are the insured's salary, salaries of co-workers who perform the same duties as the insured, salaries of family members, and depreciation.

Monthly benefits are paid upon the insured's total and continuous disability, and are limited to a maximum amount. Partial disability benefits are also available. During disability a "carry-forward" provision allows unused benefits to be carried forward from month to month. Extension of the benefit period allows unused benefits to be received beyond the original benefit period.

Waiting periods are typically either 30, 60, or 90 days. The cash flow requirements of the business are considered when selecting an appropriate waiting period.

Benefit periods are typically limited to 12, 18, or 24 months. Limited benefit periods assume that the insured will dispose of the business interest if disability lasts longer then the benefit period (see disability buy-out insurance, page 377).

Optional coverages are often similar to individual disability income policies (e.g., partial disability riders, guaranteed insurability riders, and lump-sum survivor benefits). Other optional coverages are unique to business overhead expense insurance (e.g., a professional replacement rider covering the cost of hiring someone to perform the insured's duties).

Eligible businesses include regular C corporations, S corporations, limited liability companies, partnerships, and sole proprietorships. The business must have been in operation for a minimum period of time (e.g., 3 years). The business cannot have more than a specific number of owners (e.g., 5 professionals working in the business). This requirement recognizes that a substantial loss of revenue is less likely if the business has a large number of owner-employees. There are specific issue ages and medical underwriting requirements; and the insured must be actively at work full time (e.g., a minimum of 30 hours per week).

Premiums are deductible as a business expense. Although the *proceeds* are taxable, they are used for tax-deductible business expenses (i.e., taxable proceeds are offset by deductible business expenses).

CAFETERIA PLANS

Cafeteria plans, also described as "flexible benefit" plans or Section 125 plans, allow participating employees to choose between a number of non-taxable qualified benefits or taxable cash. Plans typically offer participants a "cafeteria menu" of items, including group term life insurance, medical expense insurance, dependent group term life insurance, child care, and dental expense coverage.

Among the advantages to an *employer* that establishes such a plan are reductions in FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) taxes, expansion of employee benefits, and enhanced employee appreciation of the benefit package.

Employee advantages include the opportunity: (1) to select benefits most suited to individual needs; (2) to pay for these benefits with before-tax rather than after-tax dollars; (3) to obtain benefits that may not be available for individual purchase; and (4) to pay less FICA taxes by reducing taxable income.

The design of cafeteria plans can range from simple "premium only" plans to full-blown flexible benefit plans including flexible spending accounts. **Premium-only plans**, which are also referred to as "premium-conversion" plans, merely allow employees to use their before-tax, rather than after-tax, dollars for plan contributions. In contrast, **flexible spending accounts** allow employees to defer before-tax dollars to pay for dependent care expenses and unreimbursed medical expenses (such as deductibles and coinsurance payments, glasses, and eye exams).

The election to defer dollars must be made in advance of the plan year and can be changed only under limited circumstances. With flexible spending accounts, employees forfeit fund balances that are not used up by the end of the plan year, except for a 2½ month grace period if permitted by the plan. An additional period is allowed after the close of the plan year for submission of claims incurred during the plan year. Forfeitures may be used to offset the employer's cost of administering the plan, reallocated proportionately to other employees, or given to charity.

Former employees may participate, but self-employed individuals may not. All plans are subject to special nondiscrimination rules. Proper administration of cafeteria plans requires preparing plan documents, conducting annual enrollments, tracking claims and benefit payments, and filing yearly 5500 reports.

See also, Defined Contribution Health Plan, page 375, and SIMPLE Cafeteria Plans, page 553.

CAPITAL GAINS

If property is classified as a "capital asset," then, upon its sale, any gain generally is considered a capital gain. With increases in both federal and state ordinary income tax rates, the tax-rate preference for capital gains can be increasingly significant. Gain is the excess of the amount realized upon the sale over the basis (which might be adjusted downward for depreciation or upward for additions to the property). Gains and losses from the sale or exchange of capital assets are either short-term or long-term. Generally, in order for gain or loss to be long-term, the asset must have been held for more than one year.

Before assessing any taxes on capital gains, short-term gains and losses are netted against each other and long-term gains and losses are netted against each other. The excess of net long-term capital gain over net short-term capital loss (if any) is net capital gain.

For years beginning prior to December 31, 2012, there are essentially four groups of capital assets: (A) short-term capital assets which are taxed at normal income tax rates; (B) 28 percent capital assets, generally consisting of collectibles gain or loss, and IRC Section 1202 gain (qualified small business stock, see page 520); (C) 25 percent capital assets, consisting of assets that generate unrecaptured IRC Section 1250 gain; and (D) 15 percent and 5 percent capital assets, consisting of all other long-term capital assets. After netting gains and losses within each group, if there is a net loss from group A, it is applied to reduce any net gain from B, C, or D, in that order. If there is a net loss from B it is applied to reduce any net gain from C or D, in that order. If there is a net loss from D, it is applied to reduce any net gain from B or C, in that order. If there are net losses after the above netting, up to $3,000 ($1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary income. Any remaining net losses are carried over to other taxable years while retaining their group classifications. The tax rate on collectibles gain and IRC Section 1202 gain is 28 percent, and unrecaptured IRC Section 1250 gain is taxed at 25 percent.

Under the American Taxpayer Relief Act of 2012, beginning on January 1, 2013, there is a change for long-term capital gain rates: (1) the capital gains of taxpayers whose ordinary income is taxed at a rate below 25 percent is subject to a 0 percent capital gains rate; (2) the capital gains of taxpayers whose ordinary income is taxed at from 25 percent to below 39.6 percent is subject to a 15 percent capital gains rate; and (3) the capital gains of taxpayers whose ordinary income is taxed at 39.6 percent is subject to 20 percent capital gains rate (e.g., joint filers with taxable income above $464,850).

Under the Affordable Care Act, for tax years after December 31, 2012, there is an additional tax of 3.8 percent on passive income, which includes most capital gains. The tax is levied on taxpayers earning over $250,000 (married filing jointly), $200,000 (single taxpayers), and $125,000 (married filing separately).

See also, the discussion of Net Unrealized Appreciation on page 485.

CAPTIVE INSURANCE ARRANGEMENTS

Captive insurance (sometimes referred to as a Section 831(b) Plan) is a name given to a corporation created for the purpose of insuring against risk, usually some type of property and casualty insurance to a relatively small group of insureds, usually including the party or parties that created the Captive. These are set up when an entity believes it may be more cost effective to carve out the risk from their standard coverage. Like all insurance companies, the Captive is regulated as an insurance carrier by either a state or an offshore jurisdiction. The Captive collects premiums, sets aside reserves, and pays claims.

Captives are often used as an alternative to self-insuring certain risks. A business cannot deduct the cost of setting aside reserves to self-insure against risk. The business can only deduct the cost of self-insuring a risk when the loss is incurred, whereas premiums paid to a Captive to insure the same risk, if reasonable and meeting other certain requirements, are currently deductible. For this reason, Captives have become popular with businesses having substantial risk – like real estate developers and trucking companies.

Premium contributions made by the parent company to the Captive are deductible pursuant to Section 162 if ordinary and reasonable. If certain conditions are met, pursuant to Section 831(b), a Captive receiving less than $1.2 million of annual premium is taxed only on investment income. Thus, it is possible that the parent can currently deduct the premium under Section 162 and the Captive not take the premium into income pursuant to Section 831(b).

To obtain the tax treatment outlined above, the Captive must qualify as an insurance company. As previously mentioned, the Captive must be formed under the law of a U.S. state or a foreign jurisdiction. The Captive must operate within the guidelines of that local jurisdiction. The IRS also requires that there be both risk shifting and risk distribution. The IRS has provided safe harbor rulings defining risk distribution. In effect, the risk distribution requirement should be met if at least 50% of the premium received by the Captive relates to unrelated third-party risk or there are at least twelve entities insured by the Captive. The "twelve-insured" requirement can be satisfied by related, but separate legal, entities. The risks insured must be real and not illusory and the rates must be appropriate for the risk insured.

Although Captives are an attractive alternative for some businesses to self-insurance and commercial insurance coverage, they are not for every business owner. A Captive is a separate legal entity that is regulated by a state or offshore insurance commissioner. It has significant reporting requirements as an insurance carrier plus a complicated federal tax regime. A Captive must be adequately reserved – creating a significant initial capitalization. In summary, the cost to create and maintain a Captive can be significant. A Captive must have risk shifting and risk distribution – meaning that the premium paid by a business owner could be used to pay a claim by another business owner.

(continued on next page)

CAPTIVE INSURANCE ARRANGEMENTS (continued)

Like all insurance companies, a Captive must hold reserves that are deemed sufficient under the local law (jurisdiction of domicile) to pay future claims. Different jurisdictions have different reserve requirements as to the amount of the reserve and the type of allowable investments.

Recently, life insurance has become a popular investment for funding a Captive's reserve. The argument in favor of life insurance goes something like this: (1) the premiums are deducted by the business under Section 162; (2) the first $1.2 million of premiums received by the Captive are not taxed pursuant to Section 831(b); (3) dollars then paid into permanent life insurance products can grow income tax deferred under the rules governing cash value life insurance; and (4) life insurance cash values can be used by the business owner in retirement. In short, it is sometimes argued that Captives are a means of tax deductible non-qualified deferred compensation.

Caution should be taken when Captives are being promoted with focus on the tax deductions. Remember, the risk must be real and the amount of the premium fair to get the deduction. Captives are a means of spreading risk – not taking deductions for an imaginary risk. Life insurance may have a place in Captives, just like life insurance has a place with other businesses, but one should become suspicious when life insurance becomes the focus of the Captive. Remember that a Captive needs to be a real insurance company which complies with local law – including those governing reserves. Also, it shouldn't be forgotten that premiums paid to purchase life insurance are generally not deductible. Past attempts at creating tax-deductible life insurance arrangements have usually not been successful (see, for example, Retired Lives Reserve, page 529; Welfare Benefit Fund, page 584). Some commentators have even wondered if some of the Captive arrangements marketed today as tax-deductible non-qualified deferred compensation are governed by the IRS tax-shelter (i.e., listed transaction) rules.

In short, caution should be taken when a promoter is suggesting a Captive. That caution should be even greater when life insurance is a significant aspect of the Captive arrangement. Captives can be an effective tool in the right situation and life insurance may be an appropriate investment, but be sure that the primary purpose of the arrangement is for insuring property and casualty risk and not for retirement planning. Consultation with independent tax and legal advisors, not affiliated with the Captive arrangement, is highly recommended.

CASH BALANCE PENSION PLAN

A cash balance plan is a defined benefit plan that calculates benefits in a manner similar to defined contribution plans. Each employee has a hypothetical account or "cash balance" to which contributions and interest payments are credited. Under the typical plan a fixed percentage of each employee's salary is contributed each year, and both the level of contribution and a minimum rate of return are *guaranteed* by the employer (i.e., the employer bears the investment risk). Contributions may be weighted for age or years of service. Unlike a true defined contribution plan, individual accounts are not maintained and participants may not direct the investments in their accounts. As with the defined benefit pension plan the plan benefits are guaranteed up to specific limits by the Pension Benefit Guaranty Corporation (PBGC). See page 497.

Compared with traditional defined benefit plans, cash balance plans generally provide greater benefits to younger employees and those with shorter service (but at a higher cost), and lower benefits to older, longer service employees (at lower cost).

In an effort to reduce the costs of employee retirement plans, and offer more attractive plans to younger workers with few years of service, employers can convert their traditional defined benefit plans into cash balance plans. This conversion benefits younger workers, who not only can accrue benefits more rapidly, but will also enjoy the added advantages of portability (i.e., if the employee leaves prior to normal retirement age vested account values can be taken in a lump sum, rolled over into an IRA, or otherwise invested). However, these conversions are generally detrimental to older employees, since they occur just as these workers are reaching the age where the defined benefit formulas began to sharply raise the value of their future pension payouts. The effect is that some cash balance conversions have arguably lowered the rate of future benefit accruals. In response to this concern, the Pension Protection Act of 2006 required that future conversions of defined benefit plans to cash balance plans preclude the possibility of "wear-away" (i.e., a time after conversion during which additional benefits do not accrue).

Controversy over cash balance conversions has resulted in some employers giving employees the option of staying with the old defined benefit plan, or providing other incentives in order to mitigate loss of anticipated benefits.

See also, the discussion of qualified retirement plans on page 519.

CHARITABLE GIFT ANNUITY

A charitable gift annuity is received pursuant to a contractual obligation by a charity to make annuity payments to a donor in exchange for the transfer of property to the charity. In comparison to charitable trusts they are less costly and relatively simple to adopt, typically requiring only an application and a one or two page agreement. The donor's tax-deductible gift is measured by the difference between the market value of the gift and the value of the retained life annuity. The annuity can be immediate or deferred and for a single life or the joint lives of two annuitants.

The actual rates used to calculate the annuity payout are typically based upon those published by the American Council of Gift Annuities. The council meets periodically in order to review interest rates and mortality assumptions and update the annuity rates. Although these rates are published in an attempt to avoid "rate bidding wars" between charities, the council has no enforcement authority. However, charities using the rates need not retain their own actuaries and have the assurance that the underlying actuarial assumptions will likely produce an ultimate charitable benefit.

The annuity receives favorable tax treatment. A portion of each payment is received tax-free as a return of principal (but excludable only until the investment has been recovered, thereafter taxed as ordinary income). The remaining portion is taxed as ordinary income. However, if the donor has transferred appreciated property to the charity, the donor has a gain (either capital gain or ordinary income depending on the property) to the extent the fair market value exceeds the donor's adjusted basis. The basis in the property must then be allocated between the charitable gift and the donor's investment in the annuity contract. As a result the return of principal element of each annuity payment is divided into two parts, one representing a return of gain (taxed as capital or ordinary gain) and the other representing a return of basis (excluded from income).

The contractual obligation to the annuitant is solely the charity's and the annuity payments are dependent upon the continuing financial stability of the charity. If desired, the charity can reinsure its obligation to the donor by purchasing a commercial annuity. This relieves the charity of the burden of investing the proceeds to assure that all payments will be made to the annuitant. To the extent that the cost of a commercial annuity is less than the amount realized from the gift the excess funds become immediately available to the charity.

CHARITABLE GIFTS OF LIFE INSURANCE

Gifts of life insurance policies and premiums have become a popular way of providing substantial gifts to a donor's favored charity. When properly implemented, the donor should receive charitable deductions for the value of the insurance contract and for all future premium payments.

In order to obtain the anticipated income, gift, and estate tax deductions, the donor must make a gift of his *entire* interest in the policy. The donor will not qualify for these deductions if he retains the right to name or change the beneficiary, or gives less than his entire interest (e.g., assignment of death benefit but retention of cash values).

However, even when the donor appears to have given his entire interest in the policy to a charity, or where the charity originally applies for the insurance, a 1991 private letter ruling (withdrawn when state law changed) provided that the charity's lack of an insurable interest under state law would be a basis for denying the income, gift and estate tax deductions.

Following this ruling virtually all states have passed legislation that specifically provides that charities have an insurable interest in the lives of their donors.

The variety of state laws and likely changes to these laws make it imperative that specific state statutes be consulted prior to making gifts of life insurance and premiums, or having a charitable organization apply for life insurance (for an expanded discussion of insurable interest, see page 426).

CHARITABLE TRUSTS

Charitable trusts can benefit both individual and charitable beneficiaries. The requirements for charitable remainder trusts are specific and detailed in order to assure that an accurate determination can be made of the benefit the charity will eventually receive. Such trusts can offer both income and estate tax benefits, and include:

1. **Charitable Remainder Annuity Trusts (CRATs)** are trusts under which a *fixed amount* of at least 5 percent and no more than 50 percent of the initial fair market value of trust assets is paid annually to a noncharitable beneficiary. Payments to the noncharitable beneficiary may be for a set term not exceeding 20 years or for the life of the beneficiary. The amount of the grantor's tax deduction is measured by the present value of the charity's remainder interest at the time property is given to the trust. The value of the remainder interest must be at least 10 percent of the initial fair market value of all property placed in the trust. If the trust income is insufficient to make the required payments to the noncharitable beneficiary, then capital gains or trust principal must be used. If the trust income is more than required to make the payments, the excess is reinvested in the trust. See chart on page 55.

2. **Charitable Remainder UniTrusts (CRUTs)** are trusts under which a *fixed percentage* of the net fair market value of the trust (valued annually) is paid at least annually to a non-charitable beneficiary. This percentage cannot be less than 5 percent and no more than 50 percent. Payments to the noncharitable beneficiary may be for a term not exceeding 20 years or for life. The amount of the grantor's tax deduction is the present value of the charity's remainder interest. The value of the remainder interest must be at least 10 percent of the net fair market value of each contribution as of the date the property is contributed to the trust. See chart on page 55 and discussion of NIMCRUT on page 486.

3. **Pooled income funds** are trusts created by public charities rather than private donors. The donors, or other income beneficiaries, receive from the commingled funds in the trust an income for life that is based upon the earnings of the trust. The amount of the grantor's tax deduction is the present value of the charity's remainder interest.

4. **Charitable lead trusts** allow a grantor to place funds in trust with an annuity or unitrust interest going to a charitable beneficiary and the remainder interest returning to the grantor or some other noncharitable beneficiaries. Although the grantor continues to be taxed on trust income under the grantor trust rules, he is entitled to an income tax deduction at the time of the gift equal to the present value of the charity's annuity or unitrust interest.

CHARITY AS DESIGNATED BENEFICIARY OF RETIREMENT PLAN

Naming a charity as beneficiary of some or all of a retirement plan can be a simple and tax-efficient way to make a charitable bequest. The many benefits include the following:

1. Payments made from a tax-deferred retirement account to individual beneficiaries are considered "income in respect of a decedent" and taxed as ordinary income (see page 422). However, charities are exempt from state and federal income taxes and can receive retirement funds without any reduction for taxes paid.
2. Payments made to a charity are deductible from the gross estate and not subject to estate taxes. With larger estates this can save substantial amounts of estate taxes. (But an income tax credit is available to the beneficiaries for any estates tax paid.)
3. By satisfying charitable objectives with retirement account assets the decedent can then pass appreciated property to non-charitable beneficiaries. Since this property is entitled to a stepped-up basis at death, it can then be sold at fair market value without paying income taxes (see page 561).

Before making a charity a beneficiary, it should be determined if: (1) the plan contains any restrictions against naming a charity as beneficiary; and (2) the account holder is married (retirement plans other than IRAs require that the spouse waive his or her rights under the retirement plan). The mere naming of a charity as beneficiary will not adversely impact the calculations of the owner's required minimum distributions (RMDs) during his or her lifetime (prior rules would have prevented using the joint life expectancy of the owner and another person if a charity was a named beneficiary).

A "designated beneficiary" must be determined for the purpose of calculating the required post-death distributions from a retirement account. Designated beneficiaries are living persons for whom a life expectancy can be calculated. (An exception to this rule allows some trusts to qualify as designated beneficiaries provided they meet specific requirements.) A charity is considered to be a "non-designated beneficiary" since it has no life expectancy.

When the **charity is the only beneficiary**, the RMD is determined as if there were no designated beneficiary and there is limited flexibility as to when distributions may be taken (see page 432). However, this is rarely a concern as most charities have no tax incentive to delay distribution and want to receive the funds as soon as they are available.

When there are **multiple individual beneficiaries** (i.e., multiple "designated beneficiaries") the RMD calculation is based upon the oldest beneficiary, unless separate accounts are established before September 30th of the year following the owner's death, in which case each individual beneficiary should be able to calculate his or her own RMD (based upon their individual life expectancies).

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CHARITY AS DESIGNATED BENEFICIARY (continued)

When a **charity is among the beneficiaries**, the individual beneficiaries will be unable to use their life expectancies to calculate RMDs if the charity is included among the beneficiaries on September 30th of the calendar year following the year of the account owner's death (the deadline for determining the identity of account beneficiaries for the purpose of determining RMDs). The reason for this is that an account that has both designated and non-designated beneficiaries is treated as if it has no designated beneficiaries. However, the problem can be avoided and the individual beneficiaries can preserve their ability to stretch out annual withdrawals over the course of their lifetime by either:

1. Establishing separate accounts for the charitable and the non-charitable beneficiaries after the death of the account owner, but not later than the September 30th deadline.
2. Paying out the charity's share prior to the September 30th deadline. Unlike individual beneficiaries, a charity has no incentive to stretch out distributions from the retirement account. The individual beneficiaries may then take minimum distributions over the life expectancy of the oldest remaining beneficiary or over their individual life expectancies if the account is divided into separate accounts for each remaining individual beneficiary.

A retired married couple might wish to make a charity a partial beneficiary of their retirement assets, but be reluctant to do so because of a need to provide for the surviving spouse and a desire to leave the bulk of the account to adult children. The following beneficiary designation addresses that concern and passes a ten percent interest (a tithe) in the retirement account to a charity, with the remaining ninety percent to any surviving children, but only upon the death of the surviving spouse: "In the event of my death, transfer ownership of my Account to my spouse if he/she survives me. If my spouse predeceases me, transfer ownership of my Account to the following beneficiaries who survive me and make payment in the following proportions: Son A – 30%; Son B – 30%; Daughter C – 30%; XYZ Charity – 10%. If any of my Individual Beneficiaries predeceases me, his or her share shall be divided among the other individual beneficiary(ies) who survive me in the relative proportions assigned to each such surviving Individual Beneficiary. If there is no surviving Individual Beneficiary(ies) at the time of my death, transfer ownership of my Account to my estate (unless otherwise required by the laws of my state of residence)."

Should the **account owner's spouse die first,** then the charity would receive a ten percent interest and the adult children would receive their ninety percent interest in the retirement account. Should the **account owner die first**, the spouse would either remain a beneficiary of the account or transfer the funds to the spouse's IRA. In this event, the spouse should consider using the same beneficiary designation as above, but with the underlined text deleted. In either case, if the individual beneficiaries desire to delay receipt of their distributions over the longest possible time, it is important to take the actions set forth in paragraphs 1 or 2 above.

CHILDREN'S LIFE INSURANCE

Children's insurance, also referred to as "juvenile insurance," offers many advantages. The death proceeds can be used to pay medical bills and funeral expenses, provide a financial cushion for a grieving family or establish a lasting memorial (e.g., a scholarship fund in the child's name). Loans or withdrawals from policy cash values can be used for educational expenses, as a down payment on the purchase of a home, to start a business, or for emergency expenses. Adding a guaranteed purchase option will assure that in future years the child can purchase additional death benefits without evidence of insurability (see discussion on page 418).

Despite these advantages, placing insurance on a child's life is not without controversy. Opponents maintain that the lack of an underlying economic risk makes the purchase inappropriate and, further, that the wrong person is being insured. Clearly, if family resources are limited they should first be used to obtain adequate amounts of insurance on a child's parents (upon whom the child is economically dependent). Opponents also contend that if cash accumulations are desired it is better to save outside of a life insurance contract, thereby avoiding charges for the death benefit. Obviously, insuring a child can raise different issues than those encountered when insuring a spouse, parent, estate owner, employee, or stockholder.

Since a minor cannot directly own a policy on his own life, it is important that the individual applying for the insurance have an insurable interest in the child's life (see discussion on page 426). Initially the contract will typically be owned by a parent, grandparent, trust, or obtained as a custodial gift under the Uniform Transfers to Minors Act or Uniform Gifts to Minors Act (see discussions on pages 483 and 580).

A grandparent's purchase of insurance on the life of a grandchild can provide a meaningful gift to the grandchild while taking advantage of the gift tax laws (see chart on page 47). Virtually any form of permanent life insurance policy can be used. Single premium or limited payment plans are often used, or additional funds can be placed in a prepaid premium account (also referred to as a "premium deposit fund").

The amount of death benefit that can be purchased may be limited by state law and will be limited by insurance company underwriting standards. Purchase of a low death benefit with higher premiums will produce larger cash values. However, in making premium payments it is important to avoid classification as a modified endowment contract, since loans or surrenders of cash values could be subject to less favorable income taxation (see discussion on pages 438-439). It should also be recognized that a lower initial death benefit means that smaller amounts of additional insurance can be purchased under the guaranteed purchase option.

COLLEGE EDUCATION FUNDING

1. **Financial Aid.** In order to determine who qualifies for financial aid, a formula provided by the federal government subtracts the expected family contribution from the cost of attendance. Among other factors, this formula takes into consideration the assets and income of the parents and child. Because the formula gives substantially greater weight to the child's income and assets, large gifts should not be made to a child if financial aid is likely to be sought.

2. **Life Insurance And Annuities.** One advantage of life insurance cash values and annuities is that they are not included in the formula used by the government in determining eligibility for financial aid. Tax-deferred cash value accumulations, favorable loan provisions and a preferred status under the financial aid laws make permanent life insurance attractive for funding a college education. But there should be a real need for the insurance; otherwise, funds might better be invested where there would be no charges for a death benefit. And since a parent is most likely to be paying for college, it makes sense that a parent be the insured (with parent or trust the owner). Provided the parents are adequately insured, life insurance on the child might also be considered. However, a minor child should not be the owner of an annuity or life insurance contract (see page 483). Note also, that when the owner of an annuity is under age 59½, there is a 10-percent-penalty tax upon surrender.

3. **Gifts.** Gifts can be made to a minor under either the Uniform Transfers to Minors Act or in trust (see page 580). However, most authorities agree that the actual payment of college costs falls within a parent's obligation to support a child; therefore, such payments are not subject to gift taxation. Grandparents can take advantage of the annual exclusion to make gifts to the parents or grandchildren (see chart, page 47). Tuition costs paid directly to a university are free of gift and estate taxes.

4. **Section 529 Plans.** Also known as Qualified Tuition Programs, initial contributions to these plans must come from after-tax income. Contributions must be in cash, are not tax deductible, and are treated as completed gifts eligible for the gift tax annual exclusion ($14,000 in 2015). See the table of Educational Tax Incentives on page 313, and the discussion of Section 529 Plans on page 547.

5. **American Opportunity Credit.** This credit, extended by the American Tax Relief Act of 2012 through 2017, expands and replaces the Hope Scholarship tax credit. It provides an income tax credit of up to $2,500 per year for each of the first *four* years of college, calculated as 100 percent of the first $2,000 of qualifying expenses and 25 percent of the next $2,000. Up to 40 percent of the credit is refundable (i.e., low income students without a federal income tax liability can receive up to $1,000 a year). Books and course materials are included among eligible expenses.

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COLLEGE EDUCATION FUNDING (continued)

The student must be enrolled at least half-time in a qualifying educational institution and may be the taxpayer, his spouse or any dependent. However, the credit may not be taken by an individual who is eligible to be claimed as a dependent on another taxpayer's return. The credit may not be taken if the student has ever been convicted of a state or federal charge of felony drug possession or distribution. There is no limit in any given year as to the number of American Opportunity Credits a taxpayer may claim as to his dependents (i.e., the limit is on a per-student basis). The credit is phased out ratably between modified adjusted gross income of $80,000 to $90,000 for unmarried taxpayers and $160,000 to $180,000 for married taxpayers filing joint returns.

6. **Lifetime Learning Credit.** The Lifetime Learning Credit is 20 percent of the first $10,000 of qualifying education expenses (i.e., a maximum of $2,000 per year). The Lifetime Learning Credit limit is on a per-return basis, meaning that only $10,000 of educational expenses covering all students in the household qualifies each year. In ~~2014~~ the credit is phased out ratably between modified adjusted gross income of $55,000 to $65,000 for unmarried taxpayers and $110,000 to $130,000 for married taxpayers filing joint returns. Unlike the Hope Scholarship Credit, the Lifetime Learning Credit can be taken for any year of post-secondary education (except a year in which the Hope Scholarship Credit is claimed for the same student), does not require at least half-time enrollment, and study may be intended to improve the student's job skills and need not lead to a degree.

7. **Deducting Interest On Education Loans.** This deduction allows the taxpayer to deduct up to $2,500 of interest paid on any qualified education loan (the debt must be incurred solely to pay qualified higher education expenses). In 2015, the deduction is phased out ratably between modified adjusted gross income of $65,000 to $80,000 for unmarried taxpayers, and $130,000 to $160,000 for married taxpayers filing joint returns (as indexed for inflation). It is an "above the line" deduction, meaning that the taxpayer does not have to itemize in order to claim the deduction.

8. **Coverdell Education Savings Account.** An annual non-deductible contribution of $2,000 per beneficiary can be made to these accounts. This contribution limit is phased out ratably for individual taxpayers with modified AGI between $95,000 and $110,000, and for married taxpayers filing jointly with modified AGI between $190,000 and $220,000. Funds distributed to pay qualified education expenses are income tax-free (see page 366). These accounts had previously been known as "Education IRAs." The American Tax Relief Act of 2012 made the $2,000 per beneficiary amount permanent (it had been scheduled to be reduced to $500).

9. **Penalty-Free Withdrawals From Traditional IRAs.** Withdrawals from an IRA for qualified higher education expenses of the taxpayer are not

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COLLEGE EDUCATION FUNDING (continued)

subject to the 10-percent-penalty tax for premature distributions (but are subject to regular income taxes).

10. **Series EE Bonds and Series I Bonds.** The purchase of these bonds can provide tax-free interest if the proceeds are used for the tuition and fees of a dependent. However, there is a phase-out of this exclusion once modified adjusted gross income exceeds a designated amount (in 2015 for single taxpayers the phase-out is between $77,200 and $92,200; for joint tax return filers the phase-out is between $115,750 and $145,750).

11. **Education Expense Deduction.** This provides an above-the-line $4,000 deduction for qualified educational expenses for taxpayers in certain income ranges. The expenses must be for tuition and fees at an eligible post-secondary educational institution. For expenses paid through 2014 a maximum deduction of $4,000 is available for employees who file a single return with adjusted gross income of $65,000 or less and for those who file jointly with adjusted gross income of $130,000 or less. The deduction decreases to $2,000 for employees who file a single return with adjusted gross income that is greater than $65,000 but less than or equal to $80,000, and for those who file jointly with adjusted gross income that is greater than $130,000 but less than or equal to $160,000. The American Tax Relief Act of 2012 extended this deduction through 2013 and for the three months of 2014.

12. **Employer Tuition Reimbursement.** Also known as "educational assistance plans," or "Section 127 plans," under these nondiscriminatory programs an employee may exclude up to $5,250 of employer-provided educational assistance each calendar year. Amounts over $5,250 are included in income and subject to employment and income tax withholding (but expenses related to the employee's current job may be deductible, see paragraph 13 below). The education expenses need not be job related or lead to a degree. Covered expenses include tuition, fees, books, and supplies. Expenses for both undergraduate and graduate-level courses are covered. The American Tax Relief Act of 2012 made permanent this exclusion from income.

13. **Trade Or Business Expense.** Reimbursements to an employee outside of an educational assistance plan are included in the employee's income. These reimbursements are d*eductible* if the education expense was incurred for maintaining or improving skills required in employment – but this is a below-line deduction, meaning that the employee must itemize and the deduction is subject to a "2-percent-floor" (i.e., it is only useful to the extent that miscellaneous itemized deductions exceed 2 percent of adjusted gross income). These reimbursements are *not deductible* if the education expense was incurred for meeting minimum requirements for employment or qualifying for a new trade or business.

COMMON DISASTER CLAUSE

The term "common disaster clause," also known as a "simultaneous death provision," has been loosely used to describe a variety of clauses dealing with presumptions as to the order of death of the insured and the beneficiary. The basic intent of these clauses is to prevent the death benefit from passing to a named beneficiary if that person dies at the same time or shortly after the insured. Thus, it is an attempt by the deceased to better control the disposition of property after death. Although this discussion refers to an insured and the death benefit paid from a life insurance contract, the same concepts apply to a testator and the transfer of property under a will.

Under a "true" common disaster clause, when the beneficiary and the insured die as a result of a common disaster there is a *conclusive* presumption that the insured was the last to die, despite the fact that the beneficiary might survive the insured by days, or even months. Under the Uniform Simultaneous Death Act, enacted in almost all states, there is a *nonconclusive* presumption that the insured survived the beneficiary. However, if it can be shown that the beneficiary survived the insured, even for a moment, then the beneficiary receives the death proceeds. A "reverse common disaster clause" is used to assure that the marital deduction will be available. This clause assumes that a beneficiary-spouse survives the insured and therefore the death benefit passes to the estate of the beneficiary-spouse.

A "time clause" (or "short term survivorship clause"), on the other hand, refers not to the cause of death, but to the length of time the beneficiary must survive the insured. The time period is typically 30 days, but may be as long as six months. Periods longer than six months should be avoided if a surviving spouse is the beneficiary and the insured desires to take advantage of the marital deduction (see page 473). This is because property that does not vest in the surviving spouse within six months does not qualify for the marital deduction. For example, assume a time clause requires the spouse to survive for nine months after the insured's death. Once the spouse has survived the required nine months the death benefit is paid, but since it did not vest within six months, it does not qualify for the marital deduction, and will likely be subject to estate taxes.

Because of the difficulty of determining what time period to specify, it is often better to name contingent beneficiaries and have the insurance proceeds paid under a settlement option (other than a life income option that would terminate upon the beneficiary's death). Under such an arrangement, the primary beneficiary might receive a few payments, but the bulk of the death benefits would pass to the contingent beneficiaries upon the death of the primary beneficiary (which occurs after the death of the insured). Providing the primary beneficiary with an unlimited right of withdrawal under the settlement option would qualify the death proceeds for the marital deduction.

COMMUNITY PROPERTY

Community property is a specialized form of property ownership that exists only between a husband and wife who are considered to have an undivided one-half interest in such property during marriage. In most community property states, both spouses have an equal right and duty to manage community property, but neither spouse has the right to convert to his separate use or give away any substantial amount of community property without the other's consent (the gift can be voided by the nondonor spouse). In case of divorce, each spouse becomes a tenant in common of his share of the former community property (see footnote 1, page 13). Upon death, each may dispose of his own share of community property however he wishes. Without a will, community property passes by state law (often to the surviving spouse), with the deceased spouse's separate property passing according to the state's intestacy statute.

The ten states that have adopted some form of community property law are: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (Wisconsin uses the term "marital property"). However, community property laws are not exactly the same in each of these states. A married couple living in a community property state does not have the option of being governed by the state's community property law (except Alaska, where they may opt into the community property system). However, all community property states have provisions allowing for the partition of existing community property into separate property by gift from one spouse to the other, but this must be evidenced by a clear intention (retitling of assets will not suffice). During marriage, merely placing newly acquired property in the name of either spouse is not enough to assure that it will be treated as separate property. Prenuptial and post-nuptial agreements can be used to fix the property rights of existing or after-acquired property (but are considered invalid in some states).

Community property generally consists of: (1) property purchased during the marriage; (2) earned income during marriage; (3) fringe benefits derived from employment; (4) dividends, interest, and capital gains earned on community property; and (5) dividends and interest earned on separate property during the marriage (Texas, Louisiana, and Idaho). In addition, property that is otherwise separate property can become community property if it becomes so commingled with community property that it cannot be identified.

Separate property consists of: (1) property owned by either spouse before marriage; (2) earned income from work before marriage; (3) gifts and inheritances received before or during marriage; (4) capital gains on separate property; and (5) dividends and interest earned on separate property during the marriage (Arizona, California, Nevada, New Mexico, and Washington).

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COMMUNITY PROPERTY (continued)

A particular asset can be a mixture of both community property and separate property (e.g., purchase of home using funds earned before marriage and subsequent mortgage payments with community funds). Many community property states provide for other forms of co-ownership, such as joint tenancy and tenancy in common. For example, owning a home in joint tenancy rather than as community property avoids probate (but must be titled using explicit language). On the other hand, community property enjoys the specific advantage of getting a full step-up in income tax basis upon the death of one of the spouses (not available in common law states). There are also advantages to maintaining separate property, since it is generally not subject to pre-marriage debt or debt connected with the other spouse's separate property (but separate property could be subject to claims arising from "community debt").

Problems can occur when married couples move between community property and common law states. Common law property rights have been addressed by California's "quasi-community property" laws, whereas community property interests in common law states have been addressed by the Uniform Disposition of Community Property Rights at Death Act (adopted in a number of common law states).

When a life insurance policy is considered community property, generally one-half of the proceeds will be included in the insured's estate. But unique problems can arise when life insurance is community property. If the insured spouse dies first and the beneficiary is someone other than the surviving spouse, then one-half of the proceeds received by the beneficiary will be deemed a gift by the surviving spouse to the beneficiary, and subject to gift taxes on the surviving spouse's community share of the proceeds. If the noninsured spouse dies first, the deceased's one-half interest in the policy is included in his probate estate.

Merely naming the noninsured spouse owner of a newly issued policy will likely not avoid the policy becoming community property. The ownership designation should read: "John Doe as his sole and separate property and for his sole use and benefit," or words to that effect. With an existing policy, a transfer can be made to the noninsured spouse using a formal release of the community property interest. Thereafter, all premiums should be paid from the noninsured spouse's separate funds. If premiums are paid with both separate and community funds, one of two approaches will be used to determine the amount included in the insured's estate, either the "premium tracing" rule or the "inception of title" doctrine (see **Q 163**, *Tax Facts on Insurance & Employee Benefits (2015)*).

Buy-sell agreements involving community property business interests should contain the written consent of both spouses to be bound by the agreement. They should also include provisions limiting the disposition of stock or partnership interests upon death or divorce.

COMPANY OWNED LIFE INSURANCE (COLI)

The term "company owned life insurance" (COLI), also referred to as corporate owned life insurance, or employer-owned life insurance, is used to describe a wide variety of life insurance products that are purchased to fund both employee benefit plans and business insurance needs. These products include virtually all forms of permanent life insurance, including participating whole life, interest sensitive whole life, universal life, and variable life.

Employee benefit plans. COLI products are purchased on the lives of key employees to fund survivor income plans (chart, page 237), deferred compensation plans (chart, page 241), post-retirement medical benefits, and supplemental executive retirement plans (SERPs) (discussion, page 565). When used for funding employee benefit plans, key features of COLI products include: (1) high early cash values ranging from 50 to 90 percent of premiums; (2) underwriting considerations providing either guaranteed issue or guaranteed standard issue; (3) flexibility in funding variable benefits from both cash values and death proceeds; (4) change of insured provisions; (5) levelized commissions; (6) limited pay or vanish features; and (7) contract guarantees relating to mortality charges, expense charges, credited interest rates, and interest rates charged on borrowed funds. Tax and investment considerations often weigh heavily in the design and implementation of these plans.

Business insurance needs. COLI products are also purchased on the lives of business owners and key employees to fund a wide variety of needs related to risk planning, business continuation, and succession planning. These include entity purchase agreements (chart, page 131), "wait and see" buy/sell agreements (chart, page 147), partial stock redemptions (chart, pages 155), and key person insurance (chart, page 163).

Income Taxation of COLI Death Benefits

In response to the regrettable practice of insuring rank-and-file workers without their knowledge and consent, Congress included in the Pension Protection Act of 2006 major provisions affecting the income tax treatment of business owned life insurance policy death benefits. Employer-owned life insurance contracts, entered into after August 17, 2006, must meet certain requirements in order for the death proceeds to be excluded from taxable income. The general rule is that death proceeds from these contracts are taxed as ordinary income, except to the extent of any premiums paid for the policy. Exceptions to this general rule are based upon the insured's status, or how death proceeds are paid or used. The requirements and meeting the exceptions to the general rule are now generally referred to as Employer Owned Life Insurance (EOLI). See page 388 for a more detailed discussion of these rules.

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COMPANY OWNED LIFE INSURANCE (COLI) (continued)

The above concepts are obvious examples of "employer-owned" life insurance. Not so obvious is the application of the "related persons" provision, which treats individuals as "related" if they own more than 50 percent of a corporation (i.e., life insurance contracts owned by a majority stockholder are treated as "employer-owned"). For example, in the cross purchase agreement on page 135, assume that Owner A is a 60 percent stockholder, and Owner B is both a stockholder and an employee of the business. Insurance purchased by Owner A on Owner B's life to fund their cross purchase agreement is treated as employer-owned, and the death benefit is subject to income taxation. Payment of the proceeds to B's heirs would provide relief from taxation, but only if there had been the required notice and consent (see below).

The "related persons" provision is further complicated by application of the attribution rules. For example, assume Owner A is a 40 percent owner, Owner B (A's brother) is a 35 percent owner, and Owner C is a 25 percent owner. By family attribution B's stock is attributed to A, making A a majority stockholder (A's 40 percent + B's 35 percent = 75 percent). Insurance A owns on C is treated as employer-owned, and the death benefit is subject to income taxation. These attribution rules may even cause life insurance contracts owned by individuals, who themselves are not business owners, to be treated as employer-owned (e.g., insurance on A owned by A's spouse treated as employer-owned). Hopefully, the IRS will clarify and limit the scope of these rules. Until then, it is essential to fall within the exceptions by first meeting the following notice and consent requirements.

Notice and consent requirements. To qualify for an exception, it is essential to first meet strict notice and consent requirements. Under these requirements, the employee must: (1) be notified in writing that the employer intends to insure the employee's life and the maximum face amount to be issued; (2) be informed that the employer will be the policy beneficiary; and (3) give written consent, before the policy is issued, to being insured and consent to the coverage continuing after the insured employee terminates employment. *It is strongly recommended that notice be given, and consent be obtained, at the time an application is taken for virtually any life insurance contract that might conceivably fall within the scope of this law*. The statute provides no means of obtaining relief from these requirements. The potential cost of noncompliance is income taxation of the death proceeds in excess of premiums paid.

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COMPANY OWNED LIFE INSURANCE (COLI) (continued)

Reporting requirements. Every employer (technically referred to as the "applicable policyholder"), owning one or more employer-owned life insurance contracts issued after August 17, 2006, must file a return showing for each year: (1) the number of employees at the end of the year; (2) the number of employees insured under such contracts at the end of the year; (3) the total amount of insurance in force at the end of the year under such contracts; (4) the employer's name, address, and taxpayer identification number, and the employer's type of business; and (5) that the employer has a valid consent for each insured employee (if any consents were not obtained, the number of insured employees for whom such consent was not obtained).

CONSTRUCTIVE RECEIPT

A general rule of taxation is that income becomes taxable when it is "made available" to the taxpayer. The constructive receipt doctrine is used to currently tax cash basis taxpayers on income that is available to them, but which they have not actually received. The purpose of the rule is to prevent taxpayers from turning their backs on available income and thereby avoiding current taxation on that income. However, even though the taxpayer could, under some circumstances, currently receive the money, he will not be taxed provided his control of its receipt is subject to substantial limitations or restrictions. For example, a substantial limitation or restriction might be a forfeiture of the right to continued participation in the plan, a suspension of plan participation for a period of time, or a reduction in plan benefits.

If an employee's rights to deferred compensation are *forfeitable*, there is no constructive receipt. Even where the employee's rights are *nonforfeitable*, there will be no constructive receipt, provided (1) the agreement to defer compensation is entered into before the services are performed, and (2) the employer's promise to pay is not secured in any way.

Employers will often informally fund a deferred compensation plan through the purchase of a life insurance contract. This can be done without adverse tax consequences to the employee provided the employee has no interest in the contract and it remains the unrestricted asset of the employer and, as such, subject to the employer's general creditors. The employer should be the applicant, owner, and beneficiary of the contract. If the employee has any interest in the contract, he may be subject to current taxation.

Code section 409A has tightened up the deferral and distribution rules that apply to nonqualified deferred compensation plans. Under prior law the constructive receipt doctrine was the only restriction on the time and manner of deferred compensation *distributions* (e.g., provided a significant penalty was imposed, an employee could be given the right to withdraw funds at any time). Now a participant must make the *deferral* election before the start of the year in which the compensation is earned (prior law required that the election be made before the compensation was payable). See the expanded discussion of Section 409A on page 546.

See also, the discussion of Rabbi Trusts on page 521.

CONTINGENT OWNERSHIP

In planning their estates, clients are sometimes reluctant to give up control of policy values and death benefits. In these situations, "contingent" ownership of a survivorship life policy insuring both husband and wife can be used to provide some measure of flexibility. However, with this technique there is ongoing estate tax exposure that could be avoided by using a third party as the original policy owner (see Life Insurance Trust chart, page 51). Flexibility is achieved by maintaining individual ownership of the life insurance policy and designating an irrevocable trust as contingent owner of the policy (which could subsequently be changed to a new irrevocable trust with different provisions and beneficiaries).

Assume that husband and wife need life insurance to cover estate taxes and other estate settlement costs. They apply for a survivorship life insurance contract paying a death benefit at the death of the second spouse to die (see page 566). The policy owner should be that person who is most likely to die first. Since the husband is older than his wife, he is named policy owner (see table, pages 591-592). An irrevocable life insurance trust is designated as both beneficiary and "contingent" owner (e.g., by endorsement to the contract specifying the trust as owner upon the husband's death). One of three scenarios is likely to occur:

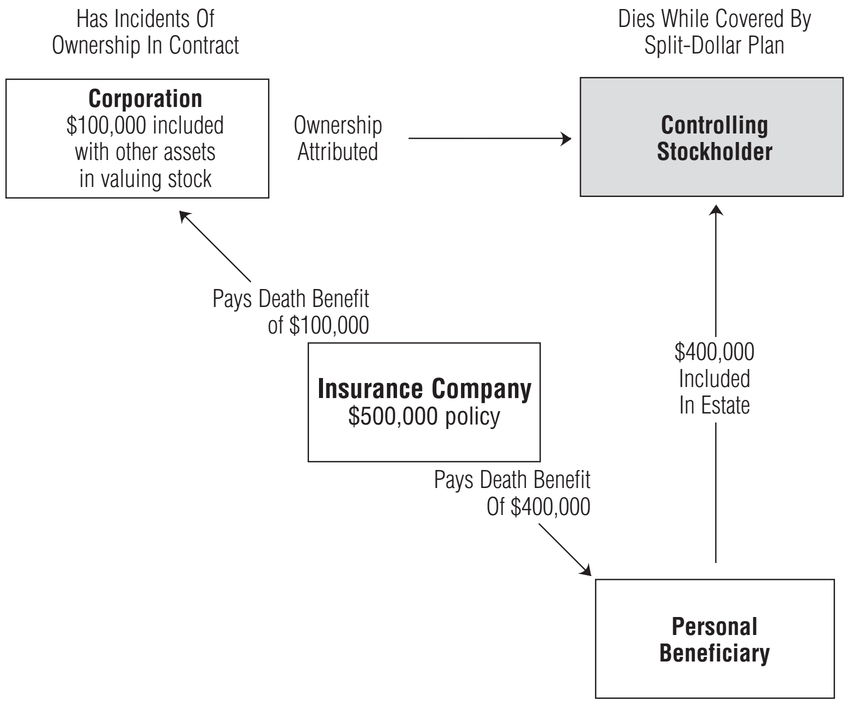
1. **Husband dies first.** The trust becomes policy owner and the value of the policy at the time of death is its interpolated terminal reserve (approximately the cash values). This is the value of the policy to be included in the husband's gross estate (because many survivorship policies provide for a large cash value increase upon the first death this amount could be substantial). Since the wife never owned the policy, upon her subsequent death the policy proceeds paid to the trust are not included in her estate.
2. **Wife dies first.** If the husband continues to own the policy, the death proceeds will be included in his estate upon his subsequent death. However, the husband could give the policy to the irrevocable trust (or to any third party), in which case the proceeds will be excluded from his estate *provided* he lives for more than three years after the gift (see pages 405-406). Although this exposure to estate taxation is aptly described as "estate planning roulette," with some clients it may be an acceptable risk if they are unwilling to give up control from the inception of the policy.
3. **Husband and wife die in a common disaster.** A "reverse common disaster" clause might be used to establish a conclusive presumption that the wife survives her husband (i.e., husband dies first). See discussion on page 354.

It is strongly recommended that this technique only be resorted to when a client is unwilling to have the insurance policy owned by an irrevocable life insurance trust. Such a trust can *assure* that both cash values and death proceeds are not subject to estate taxation (see chart, page 51).

CONTROLLING STOCKHOLDER

The concept of a controlling stockholder, also referred to as a "majority stockholder," is important with respect to split-dollar plans in which the death benefit is shared between the corporation and the insured's personal beneficiary. As with any key person insurance, that part of the *death benefit received by the corporation* on a policy insuring a controlling stockholder is included with other assets in valuing the corporation, and thus in determining the value of stock in the controlling stockholder's estate. But that part of the *death benefit received outside of the corporation* by a personal beneficiary or a trust will also be included in the insured's estate where the insured was a controlling stockholder, since any incidents of ownership held by the corporation are attributed to the insured through his stock ownership as a controlling stockholder. A person is considered a controlling stockholder when, at the time of his death, he owns more than 50 percent of the voting stock of a corporation.

Assume a split-dollar plan is funded by a $500,000 policy paying $100,000 to the corporation and $400,000 to the employee's beneficiary. Because corporate ownership is attributed to the controlling stockholder, the $400,000 death benefit paid to the personal beneficiary is included in the estate. The concept can be illustrated as follows:



Note: See the Life Insurance As Property chart on page 75, discussion in footnote 3 on page 227, and **Q 308**, *Tax Facts on Insurance & Employee Benefits (2015)*.

CORPORATE ALTERNATIVE MINIMUM TAX

The corporate alternative minimum tax (AMT) is designed to assure that the taxpayer with substantial economic income will not be able to avoid taxes merely by using available tax exclusions, deductions, and credits.

A corporation qualifying as a "small corporation" is not subject to the alternative minimum tax. A small corporation is a corporation that for its first tax year beginning after 1996 has average annual gross receipts not exceeding $5,000,000 for the preceding three-year period (if the corporation was in existence less than three years, then the test will be applied to whatever period it was in existence). Annualization of receipts is required for any short taxable year. Once a corporation qualifies as a small corporation, it will continue to be treated as a small corporation as long as its average gross receipts for the three-year period preceding the taxable year do not exceed $7,500,000.

Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest, dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are generally not reduced by the cost of goods or property sold.

The following discussion applies only to those corporations that do not qualify as a "small corporation" and therefore are subject to the alternative minimum tax.

As it applies to corporations, the AMT requires that the corporate tax base be determined with certain adjustments and increased by specific tax preferences. Two of the more common tax preference items are accelerated depreciation and certain tax-exempt interest. In the process of determining the alternative minimum taxable income (AMTI) of a C corporation, 75 percent of the amount by which adjusted current earnings (ACE) exceed the tentative AMTI is added to the tentative AMTI (or 75 percent of the amount by which the tentative AMTI exceeds ACE is subtracted from the tentative AMTI). The resulting amount is then reduced by an exemption of $40,000 less 25 percent of the excess of AMTI over $150,000. The resulting tax base is multiplied by 20 percent to determine the tentative minimum tax. The corporation then pays a tax equal, in effect, to the greater of this amount or its regular tax.

Although ACE is not equivalent to current earnings and profits (E&P), some of the adjustments used in computing ACE rely on E&P concepts. For example, life insurance will increase ACE, since under generally accepted

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CORPORATE ALTERNATIVE MINIMUM TAX (continued)

accounting principles E&P are increased by: (1) yearly cash value increases in excess of annual premiums; and (2) death proceeds (including outstanding loans) in excess of basis increased for cash value increases previously included in AMTI. Proceeds from disability income and buy-out policies payable to the corporation are also included in ACE.

Conversely, if premiums are paid for term insurance, or the cash value increase is less than the annual premium, there is a *decrease* of ACE that reduces exposure to the AMT. However, redemption of the deceased or disabled owner's stock in the same year as the proceeds are received will not avoid an increase in ACE.

The existence of the AMT does not mean that all, or even most, life insurance cash values or death proceeds will be subject to the tax. Much depends upon the corporation's taxable income, tax preference items, and other factors (e.g., S corporations are not subject to the ACE adjustment). Only a portion of cash value increases and death proceeds will be potentially exposed to this tax, since cash value increases will be partially offset by premiums; and death proceeds will be offset by cash values. Even when there is exposure, generally **the maximum rate is 15 percent** (i.e., a 20 percent tax on 75 percent of ACE). With many corporations payment of the tax will be an *acceleration of* rather than an *increase of* tax liability, since it then becomes a credit available to offset a portion of the corporation's tax liability in future years (unlimited carry forward). However, this credit may be useless to the closely held or professional corporation that will have little, if any, taxable income.

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CORPORATE ALTERNATIVE MINIMUM TAX (continued)

Impact Of Alternative Minimum Tax On Life Insurance Death Benefits Payable To C Corporation

Taxable Income	Death Benefit				
	100,000	250,000	1,000,000	2,500,000	5,000,000
0	**7,000**	**31,375**	**150,000**	**375,000**	**750,000**
	7,000	31,375	150,000	375,000	750,000
25,000	**12,000**	**37,625**	**155,000**	**380,000**	**755,000**
	8,250	33,875	151,250	376,250	751,250
50,000	**17,000**	**43,875**	**160,000**	**385,000**	**760,000**
	9,500	36,375	152,500	377,500	752,500
100,000	**28,250**	**56,375**	**170,000**	**395,000**	**770,000**
	6,000	34,125	147,750	372,750	747,750
250,000	80,750	**87,500**	**200,000**	**425,000**	**800,000**
		6,750	119,250	344,250	719,250
500,000	170,000	170,000	**250,000**	**475,000**	**850,000**
			80,000	305,000	680,000
1,000,000	340,000	340,000	**350,000**	**575,000**	**950,000**
			10,000	235,000	610,000
2,000,000	680,000	680,000	680,000	**775,000**	**1,150,000**
				95,000	470,000

Note: This chart assumes the C corporation is not exempt from the alternative minimum tax (AMT) as a "small corporation." Small figure represents that portion of the income tax that is attributable to the death benefit (i.e., additional tax imposed under the AMT calculations). The corporation is assumed to have no tax preference items. No adjustments are made for cumulative premiums paid and for possible annual cash value increases in excess of premiums paid (i.e., "basis for ACE"). As an example of how to use this chart, assume a corporation has $500,000 of taxable income in a given year and also receives a death benefit payment of $1,000,000. The corporation will owe federal income taxes of $250,000 of which $80,000 is attributable to the effect of the AMT and the receipt of the life insurance death benefit. If this corporation received the same $1,000,000 death benefit but had $2,000,000 of taxable income, the corporation would owe $680,000 in taxes, none of which would be attributable to the death benefit and the AMT. This chart also indicates that a corporation with taxable income of $1,000,000 could consider increasing its key person life insurance on a key employee from $100,000 to $250,000 without additional exposure to the AMT (i.e., the income taxes remain at $340,000).

COVERDELL EDUCATION SAVINGS ACCOUNT

A Coverdell Education Savings Account, originally called an "Education IRA," may be created for the purpose of paying the qualified education expenses of a designated beneficiary. The American Tax Relief Act of 2012 made permanent the annual non-deductible contributions of $2,000 per beneficiary that can be made to these accounts (it had been scheduled to be reduced to $500). The beneficiary must be under age 18 (except in the case of a special needs beneficiary). This $2,000 annual contribution limit is phased out ratably for individual taxpayers with modified AGI between $95,000 and $110,000, and for married taxpayers filing jointly with modified AGI between $190,000 and $220,000. Contributors with modified AGI above this phase-out range are not allowed to make contributions to an Education Savings Account. This contribution limit is per beneficiary, meaning that multiple contributors cannot exceed the $2,000 per beneficiary per year limit (e.g., if grandfather contributes $1,800 for grandson then grandmother is limited to contributing an additional $200 for grandson).

Contributions to an Education Savings Account are not tax deductible, but will be treated as completed present interest gifts from the contributor to the beneficiary at the time of the contribution. A taxpayer may claim a American Opportunity Credit or Lifetime Learning Credit for the same taxable year there are distributions from an Education Savings Account, provided the distributions are used to pay for different education costs.

When the funds are distributed to pay the beneficiary's qualified education expenses, *neither the* principal *nor the earnings will be included in the beneficiary's income*. Qualified education expenses include elementary and secondary school tuition, expenses of special needs beneficiaries, post-secondary tuition, fees, books, supplies, uniforms, equipment, and certain room and board expenses. The earnings portion of distributions that are not used to pay for qualified education expenses is not only taxed to the beneficiary, but is also subject to an additional 10-percent-penalty tax. For this purpose, the "earnings portion" means any growth in the funds in excess of the nondeductible contributions.

Any balance remaining in an Education Savings Account at the time a beneficiary becomes 30 years old (except in the case of a special needs beneficiary) or dies, if earlier, must be distributed. The earnings portion of such a distribution will be includable in gross income of the beneficiary and will be subject to the additional 10-percent-penalty tax because the distribution was not for educational purposes. However, it is possible to avoid taxation by rolling the account balance over to another Education Savings Account benefiting a different beneficiary, who is a member of the family of the original beneficiary and who has not attained age 30 as of such date (except in the case of a special needs beneficiary).

CRITICAL ILLNESS INSURANCE

Major advances in medical sciences in recent years have resulted in substantial increases in the number of people surviving a critical illness. Survival periods have also been increasing. For example, in 2006, the American Heart Association reported that 75 percent of men and 62 percent of women suffering a heart attack would be alive one year later. Advancements in treatment have caused more forms of cancer to be viewed as chronic illnesses rather than terminal diseases. Critical illness insurance is designed to provide for those suffering from, and surviving, such illnesses.

Critical illness insurance typically pays a benefit upon the *diagnosis* of the first occurrence of a named critical illness or condition. Some products provide for payments for a limited number of conditions, such as heart attack, stroke, or cancer. Other products pay upon such wide ranging conditions as Alzheimer's Disease, multiple sclerosis, major organ transplant, kidney failure, loss of sight, loss of use of two or more limbs, any terminal illness, or death.

Although often resembling the more common "dreaded disease" products, critical illness insurance typically offers substantially greater coverages and benefits. For example, proceeds might be used to provide for home health care needs, replace lost wages of the insured or a caregiver, provide for housekeeping or child care services, pay for "experimental" treatment or drugs, pay medical copayments and deductibles, or make modifications to automobiles and homes for a disabled survivor. Benefits can vary widely. The amount can be either a fixed sum or a percentage of a life insurance death benefit. Payments can be made as a lump sum or over a number of years. Typically, coverage terminates at age 65 or 70.

While critical illness insurance has apparently gained wide acceptance in the United Kingdom, Australia, and Japan, within the United States it is not available in all states. The product is likely to have wide application, not just to the married couple or business owner but also to the single person, who, after suffering a critical illness becomes his or her own dependent (traditionally a difficult market for life insurance). The proliferating consumer-directed health plans, larger medical deductibles, and lower reimbursement caps are all likely to increase interest in the product.

It is currently offered in the form of a stand-alone product, as a rider to a life insurance policy, as group insurance, or as part of a health, term life, or universal life policy. However, payment of critical illness benefits from a life insurance policy could reduce death benefits and reduce or eliminate accumulated cash values.

There is debate as to whether critical illness insurance can give the purchaser a false sense of security (i.e., the product covers only specific illnesses when there is a need for comprehensive health insurance).

CRUMMEY POWERS

By using the gift tax annual exclusion, in 2015 up to $14,000, as adjusted for inflation, can be given tax free each year to as many people (donees) as desired. However, this exclusion is available only when the donee has a right to the immediate use, possession, or enjoyment of the property that is the subject of the gift (i.e., a "present interest" in the property as opposed to a "future interest").

Although outright gifts present no difficulty with this requirement, gifts made to trusts are often subject to substantial restrictions on the beneficiaries' (donees') rights to the trust property. Under these circumstances, in order to assure the availability of the annual exclusion it is important for the beneficiaries to be given powers to withdraw gifts placed in a trust. These powers are often referred to as "Crummey powers." The term is derived from the case of *D. Clifford Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). A trust containing such powers is often referred to as a Crummey Trust.

Typically these withdrawal rights, or "Crummey powers," are exercisable only during a specific period of time (e.g., for 30 days after receiving notice of the gift to the trust). For the power to be effective, the beneficiary must receive timely notice of the gifts, but the withdrawal rights are noncumulative and will lapse after the designated period of time.

For example, an irrevocable life insurance trust might provide for each beneficiary to have "the right to demand up to $5,000, not to exceed the amount placed in the trust during the calendar year." Note that the power is usually limited to $5,000, rather than the full $14,000 allowed as the annual exclusion or the $28,000 allowed as a split-gift (the $14,000 annual exclusion is subject to indexing for inflation). Such a limitation avoids creating adverse gift and estate tax consequences for the beneficiaries of the trust (for a further explanation, see page 46). A "hanging" Crummey power used to avoid a lapse of a power of withdrawal in excess of the greater of $5,000 or 5 percent of the trust corpus should be drafted by reference to such "5-or-5" limitation and not as a tax savings clause (see footnote 4, page 53).

An alternative to the Crummey power is the cumulative power, which is a vested withdrawal right that does not lapse. Use of a cumulative power enables the trust grantor to make annual gifts of $14,000 (subject to indexing) per beneficiary without causing problems with lapsing powers of withdrawal. However, these nonlapsing withdrawal powers are always subject to being exercised in case of bankruptcy or divorce, and would be included in the beneficiary's estate.

DEATH BENEFIT ONLY PLAN

Under the usual survivor income plan, the present value of the survivor income payments is considered to be a part of the employee's taxable estate. With a larger estate, the "death benefit only plan" (DBO plan) offers a particular type of survivor income plan that can be designed to keep these benefits out of the employee's taxable estate and thereby avoid federal estate taxes. However, because of the unlimited marital deduction, there is no exposure to federal estate taxes unless benefits are payable to someone other than the surviving spouse (e.g., children or other heirs).

Typically, the employer and employee enter into a legally binding agreement under which the employer agrees to provide a specified payment, or payments, to a named beneficiary of the employee. In the agreement, it is the employer and not the employee who names the beneficiary. The actual payments are usually either a fixed amount or based upon some multiple of salary.

If life insurance is used to provide the employer with funds to meet his obligation under the agreement, the policy should be carried as key person insurance and the agreement itself should contain no specific mention of the insurance funding. As with all key person insurance, the premiums paid by the employer come from after-tax dollars, none of the premiums are included in the employee's income. Should the employee die, the employer's payments to the employee's beneficiary under the DBO plan are received as ordinary income and are deductible by the employer, provided they are considered as "reasonable compensation" for the employee's services (see page 581).

There may be some question as to whether a DBO plan would be successful in removing the death benefit from the estate of a controlling stockholder, since his voting control of the corporation gives him the right to alter, amend, or terminate the agreement.

DECANTING

Decanting refers to the revision or updating of an otherwise irrevocable trust. [The term "decant" refers to the act of pouring from one vessel to another in order to discard unwanted sediment.] Decanting statutes have introduced new flexibility into rules governing the modification of an irrevocable trust.

As of the summer 2014, the states of Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin Wyoming have adopted decanting statutes. Procedural requirements for decanting differ from state to state. Where allowed, typically all that is required is for the trustee to sign a document carrying out the decanting, provide a copy to all interested persons and file the document with the appropriate court. While court approval or beneficiary consent is generally not required to decant a trust, state laws can restrict the elimination of beneficiary rights (e.g., provision of fixed income for beneficiaries). Although decanting generally will not create income tax issues, there are gift, estate, and generation-skipping tax issues that require careful consideration by qualified tax counsel (e.g., the trustee should not be a beneficiary under the trust). As a result of decanting the original trust may be merely amended, or replaced by one or more new trusts.

The potential reasons for decanting trusts are many and varied. Decanting can be used to correct drafting errors, provide for more flexible trust administration, change governing law, assist in paying life insurance premiums, remove or add spendthrift provisions, expand trustee powers, appoint investment advisors, consolidate similar trusts, extend the trust termination date, authorize the use of investment advisors, and change from nongrantor to grantor trust or vice versa (see chart on page 67 and discussion on page 414).

In addition to decanting statutes, either specific trust language or a state's version of the Uniform Trust Code (UTC) can provide trustees with substantial flexibility to change the original provisions of an irrevocable trust. The UTC provides for the reformation or modification of trusts that are subject to the laws of states that have adopted the UTC. With *reformation*, amendments to the trust do not change the grantor's original intent. In contrast, with *modification* amendments to the trust change the grantor's original intent. Unlike the decanting statutes, changes to a trust under the UTC require a court proceeding. Generally the UTC aims to adhere to the grantor's original objectives and the trust may only be modified or terminated upon either: (1) the consent of the grantor and all of the beneficiaries; (2) the consent of all of the beneficiaries – if the trust's material purposes have been accomplished; or (3) the consent of less than all of the beneficiaries – provided the trust could have been modified or terminated if all the beneficiaries had consented and the interests of the nonconsenting beneficiaries are protected.

DECOUPLING OF STATE DEATH TAXES

Prior to the Economic and Tax Relief Act of 2001 (EGTRRA), the majority of states imposed a state death tax that was equal in amount to the allowable state death tax credit under federal law (known as a pick-up or sponge tax). Other states, that maintained an independent state death tax system, imposed a tax at least equal to the state death tax credit (i.e., the tax imposed was the greater of the state death tax credit or the separately computed state tax). Under this system of revenue-sharing, all states imposed a tax at least equal to the federal credit. For example, in 2001 the maximum federal estate tax of 55 percent was effectively split into two parts, with 39 percent paid to the federal government and 16 percent paid to the state government (lesser percentages were provided in a table for taxable estates under $10,860,000).

Under EGTRRA, the state death tax credit was eliminated and replaced with a deduction from 2005 to 2009 (for the taxpayer a deduction provides less than half the benefit of a credit). This elimination of the state death tax credit effectively repealed the state inheritance tax in those states that levied a tax exactly equal to the state death tax credit. Threatened with the loss of significant revenue, many states responded by "decoupling" from the federal estate tax. The laws designed to recoup lost revenues have taken a number of different forms, to include:

(1) **Decoupling as to the tax rate but not the exempt amount.** For example, in the chart on page 25, no state tax would be imposed on up to $5,430,000 going to the family trust (state exemption is equal to federal exemption), but upon the second death the amount in excess of $5,430,000 would be subject to a maximum tax of 16 percent.

(2) **Decoupling as to both the tax rate and the exempt amount.** For example, assume a pick-up state decouples by imposing a tax based on the law immediately prior to EGTRRA 2001 (i.e., $675,000 is exempt and the top rate is 16 percent). In the chart on page 35, placing $5,430,000 in the family trust to take full advantage of the federal unified credit would expose $~~4,325,000~~ to *state* death taxes (5,430,000 - 675,000 = 4,755,000).

Although sunset provisions provided for return of the state death tax credit, the deduction was temporarily extended through the end of 2012. However, The American Tax Relief Act of 2012 permanently replaced the credit with a deduction, effectively denying a return to revenue-sharing with the states.

To cope with the lack of uniformity from state to state, additional flexibility should be added to estate plans (e.g., post mortem planning with disclaimers, see page 380). See also the planning pointers on pages 5-7 and the discussion of post mortem planning on page 504.

DEEMED IRA

With deemed IRAs, also referred to as "sidecar IRAs," the participants in qualified plans, Section 403(b) plans, and eligible 457 plans are allowed to make traditional and Roth IRA contributions to a separate account or annuity established under their employer's plan. As to timing and limits on *contribution*, timing and taxation of *distributions*, and *reporting/ disclosure* requirements, deemed IRAs are subject to the same rules governing traditional and Roth IRAs (see pages 310, 311, 424, and 535). Compliance with the rules for traditional IRAs under Section 408, or for Roth IRAs under Section 408A, means that the account (or annuity) will be "deemed" an IRA and not a qualified employer plan.

It remains to be seen how popular deemed IRAs will become. Initially, they appear to offer the following *employee advantages*: (1) they may encourage retirement savings by facilitating the coordination of pension and IRA investments (i.e., "one-stop shopping" for retirement savings); (2) they provide the convenience of consolidation of IRA contributions, both traditional and Roth, in the same investment options as employer plan assets (i.e., for investment purposes IRA funds can be commingled with other funds in the qualified plan, but the contributions and earnings must be separately accounted for); (3) they are potentially less expensive than stand-alone IRAs; and (4) as compared to a stand-alone IRA the employer's qualified plan offers better protection from the employee's creditors. Additionally, it is also to the employee's advantage that deemed IRAs will be subject to the general fiduciary rules and claims procedures applicable to qualified retirement plans, but this is likely to be viewed as a disadvantage to employers.

DEFERRAL OF ESTATE TAX

The federal estate tax is normally due and payable in cash within nine months after death. However, special deferral provisions are available for a "closely held" business, provided: (1) the business interest exceeds 35 percent of the adjusted gross estate; and (2) the decedent was a sole proprietor, a partner in a partnership with 45 or fewer partners (or owning 20 percent or more of the partnership capital interest), or a stockholder in a corporation with 45 or fewer stockholders (or owning 20 percent or more of the voting stock in a corporation).

If an estate meets these requirements, then the estate taxes attributable to the business interest may be deferred for 4 years during which interest only is payable. Thereafter, there is a maximum period of 10 years during which annual installments of principal and interest must be paid (Code section 6166).

The interest rate was only 2 percent on the tax attributable to the first $1,470,000 in business value (as indexed in 2015 for inflation) in excess of the "applicable exclusion amount." Under prior law the applicable exclusion amount was known as the "exemption equivalent." In 2015 the applicable exclusion amount is $5,430,000 and the unified credit is $2,117,800. The tax on $6,900,000 of assumed business value is $2,705,800 and the tax on the first $5,430,000 of business value is $2,117,800 (i.e., the unified credit). Therefore, the maximum amount of tax deferrable at the 2 percent rate is $588,000 ($2,705,800 – $2,117,800 = $588,000). Any estate tax that is attributable to the business interest in excess of $588,000 is deferrable at 45 percent of the rate applicable to underpayment of tax (3 percent in the last quarter of ~~2013~~).

Before relying on the Section 6166 deferral provisions as an alternative to life insurance, a business owner should give serious consideration to **the following qualifications and restrictions**:

1. **The business** interest **must meet strict qualification standards and percentage**s in order for the deferred payment provision to be available.

2. **Not all settlement costs can be deferred**. For example, federal estate taxes on non-business assets, state death taxes, income taxes, debts, and administrative expenses must normally be paid in cash when due.

3. The interest payments are not deductible.

4. **Only a limited** amount **of tax** can qualify for the 2 percent interest rate (in 2015 the amount is limited to $588,000).

5. **All remaining** payments **may be accelerated** if either installment or interest payments are not made within 6 months of the due date, in addition to the payment of a 5 percent per month penalty.

6. **The executor is** personally **liable** for payment of the tax and must post a bond of up to twice the amount of the deferred tax unless a special IRS tax lien is placed on the estate.

7. **Extensive delays** in the final disposition of the estate will often occur when there is a deferral of the estate tax.

8. **The** tax must be paid. The deferral provisions only allow the business to continue with another creditor (the IRS) making demands on cash flow.

DEFINED BENEFIT PENSION PLAN

Under the defined benefit pension plan the employer guarantees a specified benefit at "normal retirement age." Based upon actuarial calculations the employer is required to maintain a level of "minimum funding" such as will assure that funds will be available to pay this guaranteed retirement benefit. In contrast to defined contribution pensions, such as the money purchase pension plan, there are no individual accounts.

The maximum amount of the projected annual benefit at age 65 (paid as a life annuity or as a joint and survivor benefit) is limited to the lesser of $210,000 (as indexed in 2015), or 100 percent of compensation averaged over the three highest-earning consecutive years (if normal retirement age is earlier than age 62 these maximum limits are reduced). In contrast to the money purchase pension plan, a defined benefit pension plan has maximum benefit limits but not maximum contribution limits (i.e., the regulatory concern is directed toward assuring that minimum funding standards are met). However, plan contributions must be suspended if the plan is found to be overfunded. In determining the specified benefit integration with Social Security is allowed.

Under a defined benefit pension plan the employer bears the investment risk of the plan (i.e., the employer is obligated to pay a specified benefit upon the employee's retirement). Up to specific limits the benefits of a defined benefit pension plan are guaranteed by the Pension Benefit Guaranty Corporation. See page 497.)

Various formulas are used to determine the employee's benefit: (1) **Flat amount formula** – all employees receive the same stated dollar monthly benefit without regard to the employee's level of compensation (e.g., $600 per month for life beginning at age 65). However, some minimum years of employment might be required for the maximum monthly benefit, with reduced benefits for lesser years of employment. (2) **Flat percentage formula** – each employee receives a benefit that is based upon a percentage of his average earnings (e.g., 50 percent of average earnings for life beginning at age 65). However, some minimum years of employment might be required for the maximum monthly benefit, with reduced percentages for lesser years of employment. (3) **Unit credit formula** – each employee receives a benefit that is based upon his years of employment (e.g., assuming 1¼ percent credit for each year of service an employee with 20 years of service and $100,000 of average earnings would receive a benefit of $25,000, calculated as $1.25 \times 20 = 25 \times .01 = .25 \times 100{,}000 = 25{,}000$).

Defined benefit pension plans entail high installation and administration costs, are complex to design, and are often difficult to understand. Despite these disadvantages they generally offer the older and more highly compensated employee a higher level of tax-deferred retirement savings and income.

See also, the discussion of qualified retirement plans on page 519, and the discussion of life insurance in qualified plans on pages 436-437.

DEFINED CONTRIBUTION HEALTH PLAN

The term "defined contribution health plan" describes a funding mechanism under which the employer pays a fixed amount of medical expenses on behalf of each employee. Beyond that, there appears to be little agreement among insurers, benefit managers, and commentators on how the term should be used. Under the simplest model the employer merely gives all employees a set amount of money and they are left to assemble their own health plans. But such direct cash payments to employees would undoubtedly be subject to being included in taxable income, since the employees would be under no obligation to use these funds for qualified medical expenses.

The term is more frequently used to describe various health plan models that allow employees to make decisions regarding the allocation of whatever dollars their employers are willing to contribute to an employee health plan. Under a "health reimbursement arrangement" the employer would merely reimburse the employee for medical expenses incurred by the employee from whatever source chosen by the employee (see Health Reimbursement Arrangements chart, page 253). Under other programs the employer prescreens and selects carriers and coverage parameters, and then presents employees with a menu of health care suppliers and options. See Medical Expense Programs, page 324.

Although the term "defined contribution" is often used interchangeably with "consumer-directed" health plans, it is not synonymous. Defined contribution only describes a contribution strategy, whereas consumer-directed more broadly describes the design features of a health care plan.

DISABILITY BUY-OUT INSURANCE

Disability buy-out insurance is designed to provide funds for the purchase of a disabled owner's interest in a corporation or partnership after an extended period of *permanent and total* disability. The benefits of such insurance include: (1) providing funds for the purchase, which funds are not tied to the continued success of the business; and (2) assuring that the disabled owner will no longer be a drain on business income and assets. In contrast, see the discussion of business overhead expense insurance on page 338.

A business is usually not eligible for coverage until it has been in existence for two years, although exceptions can be found (e.g., professional corporations). Maximum amounts of coverage typically range from $300,000 to $1,000,000, with specific amounts limited to a percentage of the owner's interest (e.g., 80 percent of fair market value). As with disability income insurance, definitions of disability vary widely, from inability to engage in one's "own occupation," to inability to perform the duties of "any other occupation" for which one is reasonably suited. It is *absolutely essential* that the provisions of the purchase agreement be consistent with the definitions and terms of the disability buy-out policy.

Because a disabled individual's chances of recovery are highest in the early months of his disability, the waiting period is extended and typically lasts from 12 months to three years (see disability statistics, page 325). This attempts to avoid the forced sale of a business interest while the disabled owner might reasonably expect to return to work. Benefits are paid to the "loss payee," who is that individual or business entity having the contractual obligation to purchase the disabled owner's interest (i.e., entity purchase or cross purchase, see charts on pages 131 and 135). Payment of proceeds can vary from lump sum to installment, with lump sum having the advantage of simplicity, but losing the tax advantage of spreading gain over a number of years.

Successive disabilities can cause a problem when the insured returns to work after being disabled for less than the waiting period, and thereafter suffers a second period of disability. Some policies require satisfaction of a new waiting period, while others consider both disabilities to be "continuous," provided the gap between them does not exceed a certain period. If the insured recovers after the end of the waiting period, but prior to the last indemnity payment, some policies will stop all future payments, while others disregard the recovery and make payments as originally scheduled (i.e., a form of "presumptive" disability).

Although the premiums are not tax deductible, the benefits are received tax-free by the loss payee. As with any other lifetime sale of a business interest, the disabled owner is subject to capital gains taxation of any gain on the sale of his business interest.

DISABILITY BUY-OUT INSURANCE (continued)

An alternative to traditional disability buy-out insurance is the use of a hybrid long-term care product combined with life insurance. These are usually attached to life insurance contracts in the form of a rider that carries an additional cost. Although these riders do not address the full range of disabilities, they can allow the acceleration of a life insurance death benefit when an insured has a long-term care triggering event. These are usually the inability to perform one of the traditional activities of daily living or a mental impairment. These riders may be a cost efficient alternative to true disability buy-out coverage. However, care needs to be exercised in the type of long term care rider that is selected. These riders may vary widely in terms of the ability to have a payment made to the business entity to tax efficiently fulfill the buy-out and receive funds, the circumstances under which a rider might be triggered. These are often driven by the underlying insurance carrier, the underlying filing and the state requirements.

Increasingly a number of life insurance carriers are offering long term care riders or combination products associated with their life insurance policies. For an additional premium a policy owner can accelerate some or all of the death benefit covering the insured upon the triggering of a long term care event. This does not always cover every disabling contingency but can cover many events. These can be low cost alternatives to traditional disability policies, but can also be complex. The state filing, policy structure and ownership of these products are critical. However, in the right conditions they can be effective in a business continuation setting. See Long Term Care Combination Products, page 469.

DISABILITY INCOME TAXATION

The general rule is that disability income payments under an employer's plan are included in gross income and fully taxable to the disabled employee, including both pre-retirement and post-retirement payments. However, if the payments have been received under a plan to which the employee has contributed part of the premium, that portion of the benefit attributable to the employee's contributions will be received free of income taxes. The tax treatment is the same, whether such payments are characterized as disability payments, salary continuation, wage continuation, or sick pay. See page 556 for an explanation of the taxation of Social Security disability payments.

Under some circumstances, there is a tax *credit* available to individuals who are: (1) age 65 or older; or (2) under age 65 and retired on permanent and total disability. The credit is equal to 15 percent of the taxpayer's "Section 22" amount of income for the year: $5,000 for single taxpayers or married taxpayers filing jointly when only one spouse qualifies for the credit (i.e., $750 credit), and $7,500 for married taxpayers when both qualify for the credit (i.e., $1,125 credit). If the taxpayer is under age 65, the base amount is limited to the amount of taxable disability income.

The base amount used to figure the credit must also be reduced: (1) for nontaxable pension or disability benefits received under social security, railroad retirement and certain other nontax laws; and (2) by one-half of the amount by which adjusted gross income exceeds $7,500 for single taxpayers, and $10,000 for married taxpayers filing jointly. The impact of these rules means that *no credit is available* if a taxpayer receives more than the following amounts of income:

	Nontaxable Social Security, pension, or disability benefits	*or*	Adjusted gross income
Single	$ 5,000		$ 17,500
Married filing jointly with one spouse qualified*	5,000		20,000
Married filing jointly with both spouses qualified*	7,500		25,000

* A qualified individual is one who is either age 65 or older, or under age 65 and retired on permanent and total disability.

DISABILITY UNDER SOCIAL SECURITY

In order to qualify for Social Security disability benefits an applicant must meet *all* nine of the following tests:

1. He is fully insured by: (1) accumulating 40 quarters of coverage (a total of ten years of covered work); or (2) accumulating at least six quarters of coverage provided he has acquired at least as many quarters of coverage as there are years elapsing after 1950 (or, if later, after the year in which he reaches age 21) and before the year in which he becomes disabled.

2. He has worked under Social Security for at least five of the 10 years (20 out of 40 quarters) just before becoming disabled, or if disability begins before age 31 but after age 23, for at least one-half of the quarters after reaching age 21 and before becoming disabled (but not less than six).

3. He is unable to engage in "any substantial gainful work that exists in the national economy," whether or not such work exists in the area, a specific vacancy exists, or the applicant would be hired if he or she applied for the work (however, consideration is given to age, education, and work experience).

4. Such inability results from "a medically determinable physical or mental impairment" which is expected to result in death, or which has lasted (or can be expected to last) for a continuous period of not less than 12 months. A special definition of the term "disability" is provided for individuals age 55 or over who are blind.

5. He is under 65 years of age.

6. He has filed an application.

7. He has furnished the required proof of disability.

8. He has fulfilled a five-month waiting period.

9. He accepts state vocational rehabilitation services or has good cause for refusal.

DISCLAIMER

The use of disclaimers in estate planning can often result in obtaining greater flexibility by providing the opportunity for post mortem decisions when more facts are likely to be available regarding assets, taxes, and beneficiaries. Disclaimers can be used for both tax and nontax purposes. For example, an individual might disclaim an inheritance in order to avoid losing eligibility for public benefits. Under limited circumstances disclaimers are sometimes used to benefit a charity and produce an estate tax charitable deduction. Disclaimers can also be employed outside an estate with respect to gifts, employee benefits, or life insurance proceeds.

To be effective, disclaimers must comply with state as well as federal tax law, must be made in writing prior to acceptance of the property or any of its benefits, contain an irrevocable and unqualified refusal to accept an interest in the property, and must be given to the holder of legal title to the property within nine months after the date that the transfer was made which created the interest (i.e., after death or date of gift). Because of their inherent flexibility, disclaimers have been increasingly used to deal with uncertainty (e.g., to allow a surviving spouse the opportunity to make post death adjustments to the amount placed in the family or non-marital trust under a Trust Will, see chart on page 25).

For example, the chart on page 25 shows an example of a trust will under which the testator directs that an amount equal to or less than the applicable exclusion amount be placed in the family trust ("B" Trust). Similar results could be obtained by passing all property to the surviving spouse, but with provision for a "disclaimer trust." The disclaimer trust would come into being only if the surviving spouse disclaimed, or refused to accept, a portion of the estate under the will. When funded as a result of such a disclaimer, the trust would function in exactly the same way as the family trust illustrated in the chart, except that the surviving spouse would decide exactly how much property, if any, was to go into the trust.

DIVORCE AND LIFE INSURANCE

Transfer of an existing policy incident to a divorce can generally be made without recognition of gain to the husband (this discussion assumes that property or income is being transferred from husband to wife, but the same principles apply if the transfer is from wife to husband). Because the wife is treated as having acquired the property by gift, the husband's cost basis is carried over to the wife, and since the transfer is within an exception to the transfer for value rule, the death proceeds can be received by the wife (or former wife) free of income taxes. A transfer is "incident to a divorce" if it is made within one year after the marriage is terminated or is made within six years after the divorce and pursuant to a divorce or separation instrument.

Payment of premiums pursuant to a divorce or separation agreement that qualify as alimony payments are deductible to the husband and taxable to the wife, provided the wife is owner of the policy. To qualify as "alimony": (1) the payment must be made in cash; (2) the divorce or separation instrument must not stipulate that the payments are not alimony; (3) there must be no liability to make payments after the death of the payee (wife); and (4) the parties must not be members of the same household.

Payment of death benefits to the divorced wife would be taxable as income if the policy had been owned and maintained by the husband pursuant to a divorce decree or agreement as security for post-death payments. However, if the policy had been owned by and payable to the divorced wife, the death benefits would be received free of income taxes.

DOMESTIC PARTNERS

Also referred to as nontraditional couples and unmarried partners, the term "domestic partners" includes both opposite-sex and same-sex couples. There currently exists a legal patchwork across the states on this topic. Rights and benefits afforded to domestic partners in some jurisdictions may not be available or recognized elsewhere. This is particularly true with respect to same-sex couples.

As enacted in the 1990s, the federal Defense of Marriage Act (DOMA)for all federal purposes, defines "marriage" as a legal union between a man and a woman as husband and wife, and "spouse" as a person of the opposite sex who is a husband or wife. The law, as enacted, further mandated that all federal agencies not recognize same-sex marriages and civil unions; and additionally provides that no state is required to recognize another state's laws as to same-sex marriage. The reach of this law is substantial. For example, domestic partners are not entitled to federal benefits extended to married couples relating to income taxes, gift taxes, estate taxes, Social Security entitlements, IRAs, and retirement plans under ERISA. On June 26, 2013 in the case of *Windsor vs. The United States*, the Supreme Court overturned Section 3 of DOMA which prohibited federal agencies from recognizing same sex marriages. In reaching its conclusion the Supreme Court, among other things, weighed the increased administrative burden and costs placed on same sex couples for the same benefits as heterosexual couples. The particular case turned on the recognition of a same sex marriage for federal estate tax purposes and the ruling allowed the application of the marital deduction in the federal estate tax filing for a death that occurred in 2010.

Following the *Windsor* case, the IRS has acknowledged that it will, for federal tax purposes, recognize same sex marriages. This opens up significant planning opportunities for same-sex couples who may wish to weigh amending their returns that are still open under the statute of limitations. In some instances there may be an advantage although this varies from couple to couple.

Additionally, same sex couples must now also have the same rights as heterosexual couples related to certain employer benefits. This includes the ability to a same sex spouse to receive a 401k participant's plan balance, as a spouse, unless they have previously made a written election waiving that right. Defined benefit and cash balance plans must provide a pre-retirement survivor and a qualified joint and survivor annuity to couples regardless of their status as a same sex couple. Health benefits for same sex spouses will now no longer be assessed a tax at a federal level.

Although the *Windsor* case focused on federal taxation, in the aftermath of the case each federal agency has the option to adopt its own approach to same-sex marriages. At present, however, most have adopted stances recognizing same-sex marriage, including the Armed Forces, the Department of Labor, and the Social Security Administration.

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DOMESTIC PARTNERS (continued)

The patchwork of laws becomes more complex at the state level where, even beyond possible distinct differences in taxation between federal and state tax treatment, there is the more far reaching issue of recognition of the marriage from one state to the next. Same-sex marriages are not recognized in all states. However, at the time this edition went to press, same-sex couples can legally marry in 32 states (Alaska, Arizona, California, Colorado, Connecticut, Delaware, Hawaii, Idaho, Iowa, Illinois, Indiana, Maine, Maryland, Massachusetts, Minnesota, North Carolina, New Hampshire, New Jersey, New Mexico, New York, Nevada, Oklahoma, Oregon, Pennsylvania, Rhode Island, Utah, Virginia, Vermont, Washington, West Virginia, Wisconsin, and Wyoming) and well as the District of Columbia. (see www.lambdalegal.org/states-regions). At the time this edition went to press, federal litigation challenging the constitutionality of state same-sex marriage bans was pending in the 5th, 6th, and 11th federal district courts, which control a total of ten additional states. Some states and employers provide survivor and health care benefits to domestic partners, including same-sex couples. Differences between state separate and community property laws only add further complexity.

Normally, the U.S. Constitution requires each state to give "full faith and credit" to the laws of the other states, except when it would violate the state's strongly held public policy. This runs to the heart of DOMA's Section 2, which does not require states to recognize marriages that may have been legal in the state of the ceremony. Although the *Windsor* ruling overturned Section 3 of DOMA, it did not overturn Section 2 of the Act. This adds to the complex myriad of overlapping laws and regulations.

Despite this complex and evolving legal environment and the unique issues facing domestic partners, both same sex and opposite sex, there are effective techniques that domestic partners can use in planning their financial affairs and estate plans. As with a marriage, every domestic partnership or other non-marital relationship will sooner or later end with either separation or death.

Domestic partnership agreement. It is generally acknowledged that individuals can contract for most anything, provided it is legal and not against public policy. Domestic partnership agreements, also called cohabitation agreements, are similar to premarital (antenuptial) agreements in that they provide for a division of income, expenses, and assets, as well as provisions relating to termination of the relationship.

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DOMESTIC PARTNERS (continued)

Wills. Domestic partners generally have no right to take under state intestacy laws A will, or will substitute, assuring that property passes to a domestic partner should cover issues relating to qualification of a survivor to take under the will (e.g., defining the beneficiary as "that person living with me at my death," and disqualify a survivor from taking in case of "separation due to domestic disharmony"). It is also important to define exactly those children or other heirs that are to take under the will (e.g., children born or adopted prior to or after the domestic partnership agreement).

Revocable living trusts. As a will substitute, the living trust is particularly attractive to domestic partners, as it avoids probate and reduces the chances of a successful will challenge by the decedent's relatives (see page 28). However, unlike the exemption trust will on page 24, a "marital trust" will not shield assets from the estate tax (i.e., the federal unlimited marital deduction is not available).

Gifts. Present interest gifts of $14,000 (in 2015) and gifts that use the $5,430,000 (in 2015) gift tax applicable exclusion amount are both effective with domestic partners (see page 48). However, under federal law, split-gifts are available only to a married man and woman (see page 46). A significant planning opportunity exists for same-sex couples whose marriages are not recognized. The old style Grantor Retained Income Trusts (GRIT) which is limited in its application to related parties retains its full potential with same-sex couples who are not recognized as married.

Life insurance. It is generally required that an individual who is issued a life insurance contract on another person's life has an insurable interest (see page 426). In most states, domestic partners can avoid insurable interest problems by having the policy initially issued to the insured, and then later transferring the policy by gift to the other partner. An irrevocable life insurance trust offers many advantages to domestic partners (see page 50).

Joint tenancy. Although the simplicity of joint ownership is attractive, the following should be considered: (1) federal law includes the entire value in the first decedent's estate, unless the survivor can prove contributions; (2) the account is subject to the creditors of both partners; and (3) to pass the asset at death, the title must include the words "rights of survivorship.

DOMICILE

Domicile is the place that an individual has freely chosen as the center of his domestic and legal relations. It is the place he intends to remain indefinitely. However, residence without this intention to remain indefinitely does not constitute domicile. A person can have a number of residences, but only one domicile. Once acquired, a domicile is presumed to continue until it is shown to have been changed.

The impact of establishing domicile is far reaching. It determines a person's liability for state and local income taxes; liability for state and local gift and estate taxes; potential limitations on the right to choose fiduciaries such as executors or trustees; rights of surviving spouses to take against a will; community property rights between spouses; divorce and child custody issues; availability of homestead exemptions or similar laws that reduce real estate taxes on a primary residence; where wills must be probated; how property is passed if there is no will; liability for intangible personal property tax on stocks, bonds, and savings accounts; and the ability to vote in state and local elections.

To demonstrate the intent to establish a new domicile, the following actions should be taken: (1) register to vote in state and local elections; (2) obtain a new driver's license; (3) change automobile and boat registrations; (4) file for a homestead exemption on the new residence; (5) file a declaration of domicile, if the procedure is available in the new state; (6) remain physically present in the state for over one-half of the year; (7) file federal income tax with the Internal Revenue Service Center servicing the state and include new address on returns; (8) file state and local income tax returns for the new location; (9) file state and local intangible personal property tax returns, if imposed; (10) use the new address on all legal documents (e.g., contracts, wills, bills of sale, and deeds); (11) adopt new wills and trusts; (12) provide notice of the new address to banks, credit card companies, professional associations, insurance companies, publishers, friends, relatives, and others; (13) establish new relationships with doctors and dentists and have medical records transferred to them; (14) establish new relationships with professional advisers; (15) move stock brokerage accounts to local offices; (16) open checking and savings accounts at a local bank; (17) obtain a safe deposit box and place valuables and legal documents in it; (18) apply for a passport using the new address; and (19) become active in local social, civic, and religious organizations.

See also the discussion of noncitizen estate planning on page 487.

DURABLE POWER OF ATTORNEY

A power of attorney is a written document executed by one individual, the "principal," authorizing another person, the "attorney-in-fact," to act on his behalf. Under a *general* power of attorney, the powers are very broad and authorize the attorney-in-fact to enter into and discharge virtually all legal obligations on behalf of his principal. Under a *special* power of attorney, the powers are very limited and authorize the attorney-in-fact to perform only specific functions on behalf of the principal. Typically, either power of attorney is limited to acts being performed at a time when the principal himself has legal capacity (e.g., is not deceased, disabled, mentally incompetent, or under some other incapacity).

A *durable* power of attorney authorizes the attorney-in-fact to act even if the principal is incapacitated. The durable power of attorney has been recognized in some form in all states. Such powers of attorney may be either *immediate*, giving the attorney-in-fact power to act prior to an incapacity, or *contingent*, giving the attorney-in-fact power to act only when the principal has become incapacitated. This is particularly useful in estate planning situations where it may be desired to make gifts, file tax returns, or provide for the lifetime management of assets.

See also, Health Care Power Of Attorney, page 419, and Living Will, page 468.

DYNASTY TRUST

The term "dynasty" trust is often used to describe a trust created for the benefit of multiple generations. Such trusts are also referred to as "generation-skipping," "legacy," "mega," "dynastic," or "super" trusts. They are often similar to the typical irrevocable life insurance trust, but adapted to take advantage of the generation-skipping transfer tax (GSTT) exemption. A dynasty trust can be very flexible and clients often ignore the benefits because they mistakenly believe that "generation-skipping" means that their children cannot benefit from the trust. In reality, a Dynasty Trust can be very flexible and provide significant discretion to benefit children. In reality, the "generation-skipping" refers to the payment of taxes and not the enjoyment of the inheritance.

The federal transfer tax system is designed to tax property each time it is passed from one generation to the next. To assist in accomplishing this objective, the GSTT applies an additional tax to the normal gift or estate tax whenever property is transferred to persons two or more generations younger than the transferor, or whenever there are taxable distributions or terminations from a trust (see chart, page 39). However, a GSTT exemption is available which allows aggregate transfers of $5,430,000, in 2015, to be exempt from this tax ($10,860,000 total for both husband and wife).

A dynasty trust can be created during lifetime or upon death. In order to avoid the GSTT, the donor will typically allocate a portion of his GSTT exemption to each transfer to the trust. Purchase of life insurance upon the life of the grantor, or upon the lives of trust beneficiaries, can result in a leveraging of trust assets through life insurance. Once assets are placed in the trust, and shielded from the GSTT, a properly drafted trust document would avoid subjecting the trust corpus to estate and gift taxes applicable to the trust beneficiaries (e.g., the trust beneficiaries would have no powers over trust assets such as would cause inclusion in their estates). However, a disinterested trustee could be given authority to make discretionary distributions of both trust income and corpus. Trust assets could be made available for use by trust beneficiaries and spendthrift provisions could protect trust assets from a beneficiary's estranged spouse and creditors. Special powers of appointments held by trust beneficiaries could also provide added flexibility (see page 505). In its purest form, a dynasty trust would forever avoid application of the federal estate tax by providing that trust beneficiaries in each generation never have anything more than an income interest in trust property. However, this is generally prevented by the rule against perpetuities, which requires that trust assets must vest in the trust beneficiaries after a certain period of time (see page 538). However, this limitation can be avoided by establishing a trust in those states where the rule has been eliminated by statute.

The complexity of both the GSTT and state property laws make it extremely important to seek the advice of knowledgeable legal counsel when considering a dynasty trust.

EMPLOYER OWNED LIFE INSURANCE (EOLI)

A key advantage of life insurance over other financial assets is the tax-free nature of the death benefit proceeds. However, many businesses may have lost that advantage due to provisions of the Pension Protection Act of 2006. Contrary to the general rule that life insurance death benefits are received income tax-free, death benefits paid to employers are generally taxable to the extent they exceed the employer's premium payments unless certain requirements and exceptions are met for policies that were bought after August 17, 2006, or policies that have significant changes made after that date.

To qualify for an exception that will allow the death proceeds to be received income tax free (under IRC Section 101(a), all employers must meet certain notice and consent requirements. Moreover, for all but a limited number of employees the life insurance cannot continue beyond 12 months following the separation of service following a separation from service, and still hope to receive the income tax free death benefit even if the notice and consent requirements are met. However, for certain employees, an employer may continue to own the life insurance policy and can receive the death proceeds income tax free, again, provided specific notice and consent requirements are met. See Sections 2 and 3 in the Notice and Consent Requirements Section. Note that there are certain state specific requirements for Massachusetts, New York, and Washington State.

Notice and Consent Requirements. To qualify for an exception, it is essential to first meet strict notice and consent requirements. Under these requirements, the employee must: (1) be notified in writing that the employer intends to insure the employee's life and the maximum face amount to be issued; (2) be informed that the employer will be the policy beneficiary; and (3) give written consent, before the policy is issued, to being insured and consent to the coverage continuing after the insured employee terminates employment. This must be obtained before the life insurance policy is issued. *It is strongly recommended that notice be given, and consent be obtained, at the time an application is taken for virtually any life insurance contract that might conceivably fall within the scope of this law*. The statute provides no means of obtaining relief from these requirements. The potential cost of noncompliance is income taxation of the death proceeds in excess of premiums paid.

If the Notice and Consent requirements are met then:

1. Proceeds from a life insurance contract insuring the life of an employee who was employed at time of death, or was employed within 12 months of death (this includes rank-and-file employees).

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EMPLOYER OWNED LIFE INSURANCE (EOLI) (continued)

2. Proceeds from a life insurance contract insuring the life of an individual who was (at the time the contract was issued):

   a. Among the highest-paid 35-percent of all employees, or

   b. One of the five highest-paid officers, or

   c. Received in the preceding year compensation in excess of $120,000 (as adjusted for inflation in 2015), or

   d. A 5-percent or greater owner of the business at any time during the preceding year, or

   e. A director.

3. Proceeds paid to the insured's heirs, to include:

   a. A member of the insured's family (i.e., spouse, brother, sister, ancestor, or lineal descendant).

   b. An individual who is the insured's designated beneficiary (other than the employer).

   c. A trust established for a member of the insured's family or such designated beneficiary.

   d. The estate of the insured.

   e. Proceeds used to purchase an interest (including partnership capital, or profits) in the employer from any of the above individuals or entities.

The chart that follows shows where the EOLI rules may or may not apply in certain common business owned life insurance situations.

Reporting requirements. Every employer (technically referred to as the "applicable policyholder"), owning one or more employer-owned life insurance contracts issued after August 17, 2006, must file a return showing for each year: (1) the number of employees at the end of the year; (2) the number of employees insured under such contracts at the end of the year; (3) the total amount of insurance in force at the end of the year under such contracts; (4) the employer's name, address, and taxpayer identification number, and the employer's type of business; and (5) that the employer has a valid consent for each insured employee (if any consents were not obtained, the number of insured employees for whom such consent was not obtained).

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EMPLOYER OWNED LIFE INSURANCE (EOLI) (continued)

EOLI Rules in Common Business Situations

	Probably Subject to EOLI Rules	Probably Not Subject to the EOLI Rules	Unclear, Best to Require Notice and Consent
Sole Proprietors			
Owner		X	
Employee	X		
Employer Benefit Plans			
Employer Owned – Economic Benefit Regime	X		
Employee Owned – Split Dollar Loan		X	
Employee Owned – Non Equity Collateral Assignment			X
Section 162 Bonus		X	
VEBA		X	
Qualified Plan Trust		X	
Nonqualified Deferred Compensation or SERP	X		
Death Benefit Only (DBO) Plan	X		
Rabbi Trust	X		
Business Planning			
Key Person	X		
Redemption	X		
Cross Purchase – majority owner	X		
Corporate Cross Purchase – policy owned by a minority owner		X	
Cross Purchase – policy owned by a partnership, LLC or LLP			X
Charitable Owned Coverage – otherwise tax exempt			
Employee			X
Donor		X	

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

An employee stock ownership plan, or ESOP, is a stock bonus plan, or a stock bonus plan combined with a money purchase plan, that is designed to invest primarily in the common stock of the employer (see pages 484 and 551). However, unlike a pure stock bonus plan, the ESOP is typically used as a device for implementing the business continuation and estate planning objectives of its stockholders. The benefits provided by an ESOP are similar to those provided by a profit sharing plan, but they are distributable in stock of the employer, and contributions are not dependent upon employer profits.

An ESOP must meet specific requirements pertaining to coverage, nondiscrimination in contributions, limits on contributions, diversification of investments, and nonforfeiture of rights upon termination of employment. If these requirements are met, then the plan can be useful in:

1. Motivating employees toward increased productivity (the value of corporate stock held by the trust is dependent upon the corporate profitability).

2. Providing retirement income as a supplement to Social Security and other retirement benefits.

3. Generating liquidity for principal stockholders through the sale of stock to the ESOP during lifetime or after death.

4. Securing funds for corporate growth and expansion with untaxed dollars.

5. Avoiding taxation of accumulated earnings.

6. Securing income tax deductions for an employer with little or no cash outlay.

7. Paying for life insurance on key employees with before-tax dollars.

Leveraged ESOP. A "leveraged" ESOP can be used to borrow money from a financial institution based on the credit (and guarantee) of the employer. (Normally, loans or extensions of credit between an employer and its plans are "prohibited transactions," but the ESOP is exempt from these restrictions.) The borrowed funds are then used by the ESOP trustee to purchase stock from the employer. In turn, the employer typically uses these funds to finance expansion and capital purchases.

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EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) (continued)

Subsequent employer *contributions* to the ESOP are used by the ESOP trustee to repay the debt. In effect, provided employer contributions to the ESOP are within the annual additions limitations, this technique has enabled an employer to: (1) obtain funds for expansion by selling shares to the ESOP; and (2) repay the ESOP's bank loan with fully tax deductible dollars (i.e., in the form of deductible contributions to the ESOP). Had the employer borrowed the funds directly the interest payments would have been deductible, but repayment of principal would not have been deductible.

Distributions to employees may be made entirely in cash or partly in cash and partly in employer securities. Participants must be given the right to demand the entire distribution in the form of employer stock. If the stock is not readily tradable on an established market the participants must also be given the right to require the *employer* to purchase any distributions of employer stock made to them (a "put option").

It has been suggested that the complexity of establishing a leveraged ESOP is usually not necessary since the same tax benefit can be accomplished if the employer borrows funds directly from a financial institution and contributes an amount of its stock to a stock bonus plan each year equal in value to the amount of its loan repayment.

Non-Leveraged ESOP. ESOPs are also used to purchase an owner's stock interest upon death (sometimes referred to as a "non-leveraged ESOP"). These arrangements entail giving the ESOP an *option* to purchase stock upon the stockholder's death. To fund the purchase the trustee of the ESOP acquires life insurance on the life of the stockholder. However, requiring the ESOP to purchase the stock under a formal stock purchase plan should be avoided, since it is likely that this purchase would be treated as a fully taxable stock dividend paid by the corporation to the estate. In contrast, if treated as a sale the transaction would likely produce little or no taxable gain due to the estate's stepped-up basis in the stock ~~(see page 550).~~

EQUITY SPLIT-DOLLAR

Under a split-dollar plan the term "equity split-dollar" is derived from the employee's interest in policy cash values (i.e., the employee has an "equity" interest). By sharing the ownership of cash values and limiting the employer's interest in the policy to its cumulative premium payments it was often possible for the employee to accrue substantial interests in the remaining cash values, with little or no adverse income taxation.

Until the final split-dollar regulations issued in 2003 there had been a great deal of uncertainty surrounding the tax treatment of equity split-dollar. However, Notice 2002-8 (issued in January of 2002) and proposed regulations (REG-164754-01 released in July of 2002) appeared to provide workable transition rules, safe harbors, and limited grandfathering of existing plans. The final split-dollar regulations (Treasury Decision 9092 issued in September of 2003) generally adopted the proposed regulations and dramatically altered the tax treatment of split-dollar plans. The tax treatment of new split-dollar plans is now governed by policy ownership.

Plans Established Prior To September 18, 2003

To better understand the transition rules for existing split-dollar plans and the application of the regulations to new split-dollar plans, it is helpful to break plans out according to the date they were entered into:

1. In split-dollar plans *entered into before January 28, 2002, and terminated before January 1, 2004*, the employee's equity will not be taxed. In split-dollar plans entered into before January 28, 2002, and terminated on or after January 1, 2004, the employee's equity will not be taxed, provided the plan is converted to a loan from the employer to the employee for all periods beginning on or after January 1, 2004 (if the plan is not converted to a loan, the employee will be taxed on all equity if the plan is eventually terminated). See the treatment of Employer/Employee Split-Dollar Plans (Table A) on page 301.

2. In split-dollar plans *entered into on or after January 28, 2002 and before September 18, 2003*, if the plan has not been converted to a loan the employee is subject to taxation on all equity in excess of the employee's basis when the plan is terminated (employee basis does not include amounts reported or paid for life insurance protection). But if the plan is not terminated the employee will not be currently taxed on equity as it builds up, provided the employee continues to report the receipt of the economic benefit and the employer retains some economic interest in the policy. See the treatment of Employer/Employee Split-Dollar Plans (Table B) on page 302.

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EQUITY SPLIT-DOLLAR (continued)

Plans Established After September 17, 2003

In split-dollar plans entered into after September 17, 2003 (or prior plans that are "materially modified") taxation of employee equity depends upon how the plan is structured. Based upon policy ownership the split-dollar regulations use a formalistic, yet straight forward, approach in providing two "mutually exclusive regimes" (or methods) for the taxation of split-dollar plans (see also Table C on page 303).

Economic Benefit Regime. This regime applies when the *employer* owns the contract and the employee's death benefit is accomplished by a policy endorsement (known as endorsement split-dollar). (By exception this regime also applies when the employee owns the contract but the employer owns all cash values – see Split-Dollar Insurance chart, page 225.) In addition to being taxed for the value of the life insurance protection (i.e., the "economic benefit" as imputed income), the employee is also taxed on any increased interest in policy cash values (not just at rollout). Also, if the policy is subsequently transferred from the employer to the employee the employee is taxed on any employer equity (see Split-Dollar Rollout, page 558). The employee's basis in the policy is equal to the amount paid at the time of transfer, but *does not* include amounts that had been taxed to the employee on account of prior increases in policy cash values and amounts reported or paid for life insurance protection. Any premium amounts contributed by the employee are taxable income to the employer. Given these harsh rules it is doubtful whether the employee should be given an equity interest in plans established and taxed under the economic benefit regime. However, nonequity endorsement plans taxed under the economic benefit regime avoid many of these adverse tax consequences (see Split-Dollar Insurance chart, page 225).

Loan Regime. This regime applies when the *employee* owns the contract and collaterally assigns the policy cash values to the employer in order to secure repayment of the employer's premium advances (known as collateral assignment split-dollar). Because he already owns the policy and is obligated to repay any employer loans the employee is not taxed on the equity interest in policy cash values.

Each premium payment by the employer is treated as a separate loan to the employee ("deemed loan" in the chart below). If the employee fails to pay an adequate rate of interest they are classified as below-market split-dollar loans and he is considered to have received compensation equal to the foregone interest (taxable to the employee and deductible by the employer). This foregone interest is then imputed back to the employer (taxable to the employer but not deductible to the employee since it is considered personal in nature). The complexity of *loan regime* taxation, as illustrated in the following chart, should be compared with the simplicity of *economic benefit regime* taxation, as illustrated in the chart on page 225.

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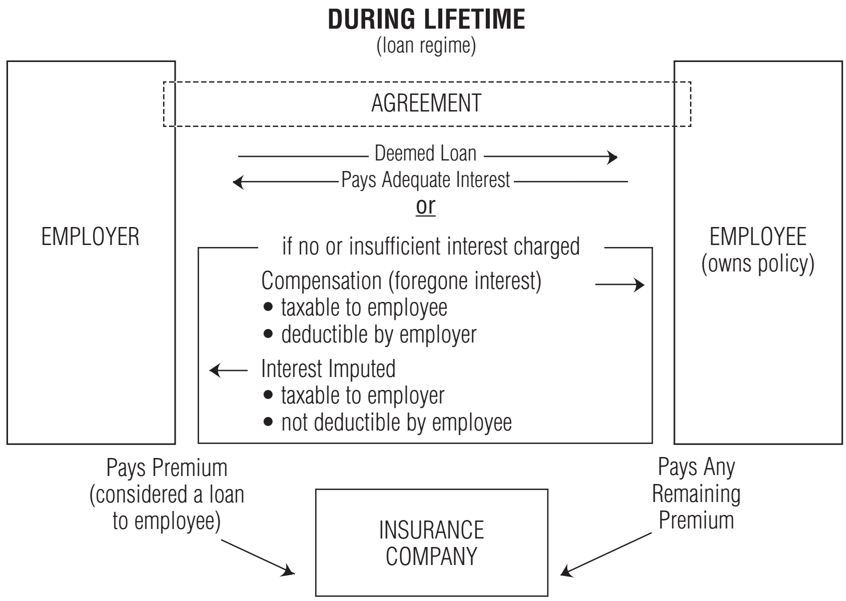
EQUITY SPLIT-DOLLAR (continued)



For the purpose determining whether the employee has paid an adequate rate of interest loans are generally classified as either demand loans or term loans.

1. **Demand loan.** A split-dollar demand loan is due in full upon demand of the employer. If the employer reserves the right to terminate the split-dollar plan it is a demand loan (e.g., upon the employee's terminating his employment). These loans are tested each year for adequate interest by comparing the interest rate to the *blended* applicable federal rate (AFR) published in July of each year (in 2014 this rate was 0.28 percent). The foregone interest for that particular year is taxed as shown in the chart above. Classification as loan offers the advantages of being relatively easy to calculate with taxation spread over the term of the agreement, but has the disadvantage of being subject to yearly changes in the blended AFR.

   For example, assume the employer advances a $10,000 premium payment without interest in a year in which the blended AFR is 6 percent. The employee includes $600 in income ($10,000 x .06). Each employer premium payment is considered a separate loan and each loan must be tested every year for adequate interest rates.

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EQUITY SPLIT-DOLLAR (continued)

2. **Term loan.** A split-dollar term loan is any loan that is not a demand loan (e.g., a loan payable in full in 15 years). Loans payable upon the death of the insured are also treated as term loans. The amount of the interest over the period of the loan is discounted to present value and then all of the interest is taxed in the very first year (i.e., all up-front). Classification as a term loan offers the advantage of knowing the interest rate for the loan's duration (it is not redetermined annually), but has the distinct disadvantage of being accelerated to the first tax year in which the loan is created (i.e., borrower must include all of foregone interest in the very first year, but lender reports interest income ratably over the term of the loan). The appropriate applicable federal rate (AFR) is based upon the original term of the loan (short-term for loans of 3 years or less, mid-term for loans between 3 and 9 years, and long-term for loans greater than 9 years). These AFR rates change monthly (in July of 2014 the AFR was 0.31 percent for short-term loans, 1.82 percent for mid-term loans, and 3.06 percent for long-term loans).

   For example, assume the employer advances a $10,000 premium payment repayable in 15 years without interest. Also assume that the AFR for a long-term loan is 5 percent. Discounted at 5 percent the present value of $10,000 payable in 15 years is approximately $4,810 ($10,000 times the factor of .4810 as obtained from the table on page 600). The employee is taxed on $5,190 (the difference between the $10,000 loan and the present value of the $4,810 repayment amount).

Sarbanes-Oxley Act. This law generally makes it a *crime* for any publicly traded company to make loans to officers or directors (the law does not apply to closely held companies). Enforcement of the Act falls within the jurisdiction of the Securities and Exchange Commission (SEC) and the SEC has yet to provide any guidance regarding its impact on split-dollar plans.

It is likely that new split-dollar plans taxed under the loan regime (employer premium payments considered employee loans) are prohibited, whereas new split-dollar plans taxed under the economic benefit regime are not prohibited (i.e., plans providing only death benefit protection for the employee). As to existing split-dollar plans, it is not clear whether the "grandfathering" provisions of this Act will apply (e.g., employer-paid premiums secured by employee-owned cash values considered as extensions of outstanding credit). Pending clarification, it may be prudent to consider: (1) using existing cash values to pay premiums; (2) reducing coverage to obtain a paid-up policy; or (3) paying premiums with employee bonuses.

EQUITY-INDEXED PRODUCTS

These are life insurance and annuity products where the crediting rate is tied to the performance of an index (most commonly the S&P 500, but it can involve other indices). These products have been available for some time, but they have become popular only since late 2010 as the Securities and Exchange Commission withdrew a proposal that might have treated equity indexed annuities as regulated products. That proposal, Rule 151A, was withdrawn after the rule was vacated by the U.S. Court of Appeals for the District of Columbia in July 2010. Under proposed Rule 151A the SEC could have considered an equity indexed annuity a security that would have required selling agents to be equity licensed.

The workings of an EIA can be quite complicated and it is important to fully understand the product. (Because they can have so many "moving parts," the following discussion provides, at best, only a general outline of Equity indexed products. Individual contracts can vary greatly from company to company. Second and third generation products are being introduced with new features and new complexities.

Equity indexed products are particularly attractive to individuals who are concerned about the safety of principal but who want the opportunity to experience market related gains. Typically a premium payment is allocated to one or more indices offered by a carrier. Although the premiums are credited to the carrier's general account (as opposed to a variable product with separate accounts).

Insurance companies typically fund indexed products by investing in high grade bonds in order to cover the end-of-term guarantee of principal, pay commissions and make a profit. However, a portion of the remaining funds are used to purchase options (i.e., the right to purchase stock at a fixed price at some future time). If the market goes up selling the call options provides funds for meeting the contract obligations.

The most common index is the S&P 500 for a one-year period. Other indices and time periods (two, three, and five years) are also common. Based on the performance of that index more or less might be credited to the policy owner.

Generally the policy owner will receive credit to their policy based on the performance of the selected index up to a certain cap. For example in a year where the S&P index increased 20%, a policy with a 12% cap will credit 12% to the policy owner's contract. There are wide variations in how the crediting works with certain contracts offering percentages of the underlying index and other contracts offering no cap, or limit, to the crediting.

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EQUITY-INDEXED PRODUCTS (continued)

The attraction of most indexed products is that there is a floor below which the credit rate cannot fall. This is the most meaningful difference between an equity indexed product and a variable life insurance contract. Typically the floor is zero, although some carriers may offer a slightly higher floor. The attraction is that in a period of time where the selected indices have negative performance (there is a loss below zero) the policy will not be reduced in value. In effect, prior year's crediting is locked in.

In reality there are multiple moving parts to an equity indexed product. For example, carriers may offer high cap rates and, therefore, high illustrated rates. However, there may also be high internal charges within the contract, effectively negating the benefit of a credit received by a high cap rate. A credit to a policy is often not received until the end of the index period (again, often one year). Carriers may charge policy expenses in a variety of ways even before a policy credit is received; this can have an effect on long-term policy performance. Additionally, in years where there is little or no crediting to the policy, internal charges will continue to be assessed on the policy.

Unlike the other methods, this has the effect of locking in gains and annually resetting the starting point of the index. Earnings are typically not credited until the end of the term, thus there is no compounding of interest earned. Averaging can be done daily, monthly, or annually. The usual effect of averaging is to increase the rate in a decreasing market and reduce the rate in a rising market (e.g., averaging the monthly gains the first year would likely result in less than 11.57 percent gain).

A cap (maximum rate) may be set on annual gains in the contract. The participation rate is the percentage of the index movement that will be credited (this can vary widely from 60 to over 100 percent). Some contracts guarantee the participation rate for the term of the contract, while other contracts reserve the right to change the participation rate or even lower the cap.

In effect, equity indexed products offer upside potential with downside protection. However, the long-term performance of these policies remains to be determined. Although numerous carriers show how their indices might have performed based on historic averages, many of these indices did not offer options for much of these periods. As a result true back-testing may not be available. Moreover, future performance is impossible to predict.

ERISA

The purpose of the Employee Retirement Income Security Act of 1974 (ERISA) is to protect the interests of workers and their beneficiaries who depend on benefits from employee pension and welfare plans. Among other things, the law requires disclosure of plan provisions and financial information, establishes standards of conduct for trustees and administrators, and sets up funding, participation, and vesting requirements for pension plans.

ERISA covers employee pension and welfare plans that are established or maintained: (1) by any employer engaged in commerce or in any industry or activity affecting commerce; or (2) by an employee organization or organizations representing employees of such employers.

A **pension plan** includes any plan that provides *retirement income* to employees or results in a *deferral of income* by employees to the termination of employment or beyond.

A **welfare plan** includes any plan that provides medical, surgical, or hospital care, or benefits in the event of sickness, accident, *disability*, *death*, or unemployment (other miscellaneous benefits are also covered).

Title I, Subtitle B, of ERISA contains requirements relating to the following:

Part 1 - Reporting and Disclosure
Part 2 - Participation and Vesting
Part 3 - Funding
Part 4 - Fiduciary Responsibility
Part 5 - Administration and Enforcement

Deferred Compensation Plans

Unfunded deferred compensation plans for a select group of management or highly compensated employees are generally considered pension plans and are subject to the following requirements:

Part 1 - Reporting and Disclosure. Can comply with by: (1) providing a letter to the Secretary of Labor giving the employer's name and address, IRS identification number, a statement that the employer maintains a plan or plans primarily for the purpose of providing deferred benefits for a select group of management or highly compensated employees, and the number of plans and number of employees in each plan; and (2) providing plan documents to the Secretary of Labor upon request.

Part 2 - Participation and Vesting. Not applicable.

Part 3 - Funding. Not applicable.

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ERISA (continued)

Part 4 - Fiduciary Responsibility. Not applicable, unless considered a welfare benefit plan because death or disability benefits are provided. Can then comply by naming the employer, through one of its officers, as the plan's fiduciary. These requirements may be met in a properly drafted deferred compensation agreement.

Part 5 - Administration and Enforcement. Can comply by providing a definite procedure for handling claims, including providing a written explanation of any denial of benefits. These requirements may be met in a properly drafted deferred compensation agreement.

Split-Dollar Plans

Plans providing split-dollar insurance are generally considered welfare benefit plans under ERISA and are subject to the following requirements:

Part 1 - Reporting and Disclosure. Compliance is generally dependent upon the type of split-dollar plan, for example:

1. A noncontributory split-dollar plan (e.g., an endorsement employer-pay-all plan) for a select group of management or highly compensated employees is exempt from these requirements, except for the requirement that plan documents be provided to the Secretary of Labor upon request.
2. A contributory split-dollar plan (e.g., a collateral assignment plan) having less than 100 participants is also exempt from these requirements, except for the requirement that plan documents be provided to the Secretary of Labor upon request and the need to provide the employee with a summary plan description. Generally, the summary plan description requirement can be satisfied by providing the employee with a copy of the split-dollar agreement and any policy ledgers prepared as part of the proposal.

Part 2 - Participation and Vesting. Not applicable.

Part 3 - Funding. Not applicable.

Part 4 - Fiduciary Responsibility. Can comply by naming the employer, through one of its officers, as the plan's fiduciary. Additionally, the plan documents must set forth procedures for funding the plan, allocating operational responsibilities, amending the plan, and making payments from the plan. These requirements may be met in a properly drafted split-dollar agreement.

Part 5 - Administration and Enforcement. Can comply by providing a definite procedure for handling claims, including providing a written explanation of any denial of benefits. These requirements may be met in a properly drafted split-dollar agreement.

ESTATE EQUALIZATION

For many people, dividing property among heirs is among the most difficult aspects of estate planning. The family home, a vacation property, antiques, and art are sometimes very difficult to divide because of the personal nature of the property.

However, for a business owner, estate equalization can be an even greater hurdle to effective estate planning. Take for example, David, a business owner with three children. He has an estate valued at $4.5 million – primarily stock in a family business. One of the children (Kevin) is active in the business and appears to be the natural successor. A second child (Mark) has an office, but he is rarely seen at the business. The third child (Randy) lives out of the state and has shown no interest in the family business. How does David divide his estate?

Should he leave one-third of the stock to each of the three children? If he does that, will the three children each have a one-third vote? That arrangement nearly guarantees that the business will not succeed after David's death. He could reconfigure the stock into voting shares and non-voting shares and leave one-third to each child – leaving the voting stock to Kevin. That arrangement provides a better chance of long-term success, but is it fair to Kevin? He is now being asked to run the family business for the benefit of his siblings. Will Mark and Randy allow Kevin to run the business without interference?

David could simply disinherit Mark and Randy and leave the business to Kevin. But, of course, that result probably insures that Mark and Randy will have nothing to do with Kevin after their father's death. Maybe the most important aspect of estate planning is preservation of family harmony. This strategy almost insures that the family will be torn apart after their father's death.

Life insurance is often the solution to difficult situations like this. Assuming he could qualify medically and financially, David could purchase $9 million of life insurance. The entire $4.5 million business could be given to Kevin so he could run the business without interference from his siblings. Mark and Randy could each be given $4.5 million of insurance to equalize the estate. This approach is sometimes known as the "equal amount" approach to estate equalization.

On the other hand, even if David could afford and qualify for $9 million of life insurance, is it fair to leave the same amount of property to all three kids when only one of the three is active in the family business? Another common approach is to purchase $3 million of insurance to divide between Mark and Randy. Kevin would get the entire family business and Mark and Randy would get $1.5 million of insurance proceeds. This leaves them with the amount that they would have received if the original $4.5 million estate had been divided equally among the three children. This approach is sometimes referred to as the "equal share" or "equitable division" approach.

ESTATE FREEZES

Intra-family transfers of property, particularly closely held businesses, have always garnered the attention of the Internal Revenue Service and Treasury. They have long questioned the valuation of certain business interests and whether gifts of interests made to family members were made at their true value.

Estate freeze techniques, such as splitting a corporate business interest into preferred stock, with priority rights in income distributions, and common stock, with appreciation potential have long caught the eye of the IRS. These bifurcations of business interests and value typically froze the current value in the preferred stock, which retained distributions of the business as evidence of their preferred status and the current business value. This devalued the common stock, which could be gifted with little or no transfer tax consequences, but these shares were designed to capture future appreciation. The IRS's belief was that the preferred interests were designed to minimize gifts of the business interest to the younger generation(s), but that the freeze may not have been properly valued for gift tax purposes. They often believed the older generation had little or no interest in retaining a preferred income stream, as that might continue to build their asset base.

As a result of these concerns, Code sections 2701-2704, together referred to as "Chapter 14," contain special valuation rules that govern the gift tax value of many intra-family transfers. These sections do so by assigning a zero value to specific retained interests unless the retained interest is entitled to defined "qualified payments."

With Chapter 14 it is still possible for a stockholder to freeze the value of a retained corporate interest (the preferred stock) and have a minimal gift tax value assigned to the common stock given to family members (see chart on page 175). However, careful detail and compliance with the guidelines established in Chapter 14 is critical. To enforce the values represented by the older generation when making reduced gifts to younger generation(s) this section of the Tax Code has established recapture rules. These ecapture rules insure that the stockholder actually receives the anticipated dividends that are claimed to increase the value of the retained preferred stock (similar rules apply to partnership interests).

These valuation rules affect three categories of retained rights:

1. A cumulative distribution right with a preference upon liquidation is generally valued as the present right to future "qualified payments."
2. A noncumulative distribution right, or one that lacks preference upon liquidation, is valued at zero unless a "qualified payment" election is made.
3. A retained liquidation, put, call, or conversion right is valued at zero, unless the right must be exercised at a specific time and amount, or the right contains certain provisions which insure that its holder can share in appreciation.

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ESTATE FREEZES (continued)

For example, assume that pursuant to a recapitalization a stockholder transfers common stock to a family member and retains *noncumulative* preferred stock (item 2 above). Since the preferred stock (the retained interest) does not encompass a "qualified payment" (cumulative rights), the retained right is valued at zero. This has the result of no premium being assigned to the preferred shares, meaning that the common stock represents the entire value of the corporation and is subject to gift taxes on that amount. To avoid this result, the transferor could elect into "qualified payment" treatment, with dividends to be paid in the amounts and at the times specified in the election.

Alternatively, assume that after the transfer of common stock to a family member the transferor retains *cumulative* preferred stock with a liquidation preference (item 1 above). In this instance, the transferor has retained a right to a "qualified payment" (i.e., to a dividend payable on a periodic basis and at a fixed rate or at a variable rate with a fixed relationship to the declared market value at the time the interests were created). The value of the gift of common stock is then determined by subtracting the value of the present value of these qualified payment/preferred stock interests from the total value of the corporation. The effect is that the common stock will have substantially less gift tax value. However, this reduction in the value of the common stock is limited by a provision requiring that all common stock (termed the "junior equity" interest) be given a value of at least 10 percent of the total value of the corporation (which, for this purpose, includes a gross-up equal to the total amount of corporate indebtedness to the transferor and family members).

It is important to note that the Tax Code sections that make up Chapter 14 only apply to specified family relationships. For the statute to apply: (1) the transfer must be to the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and the spouses of such descendants; and (2) the transferor and applicable family members immediately before the transfer must "control" the entity by owning, by vote or value, 50 percent of the stock. For purposes of this 50 percent "control" a person is treated as holding (aggregating) any interest(s) held by his ancestor or his spouse's ancestor, or a spouse of such ancestor, or a lineal descendant of his parent or his spouse's parent (see Degrees Of Kindred chart, page 104).

The valuation rules assume that payments on the cumulative preferred will be made as scheduled. If payments are not made in accordance with a statutorily provided grace period, the rules provide for additional gift tax to be paid at the time of a subsequent lifetime transfer, or for additional estate tax at the death of the transferor (i.e., recapture). The increase in the taxable gift or taxable estate is the compounded value of the unpaid dividends using the same discount rate employed in determining the preferred stock's value.

Excluded from the scope of these valuation rules are interests in publicly traded stock, interests of the same class as the transferred interest, and interests that are proportionately the same (without regard to differences relating to nonlapsing voting power).Chapter 14 encompasses a wide range of planning techniques where discounted interests might be transferred, which are discussed elsewhere in this book.

ESTATE PLANNING STRATEGY: LEGACY FLOOR

When the federal estate tax exemption was $1 million, many life insurance agents didn't look past funding for the estate tax liability as a strategy with their clients. The life insurance "need" on nearly all permanent life insurance sales was sold as "estate tax liability" or "estate planning." But, in many cases, was that really the case?

Let's look at an example. James is 60 years old. He is reaching retirement age and has accumulated $5 million in assets. After looking at his retirement needs, he has ear-marked $2.5 million of his current assets for his heirs. Given solid investment, he hopes that he can grow his projected legacy from $2.5 million to $4.5 million. Given his approximate 20 year life expectancy (see page 594), this should be very realistic goal for James. But, reality is that nearly 20% of 60 year old males will not survive to age 70. And, by definition, life expectancy means that point where half a population is deceased. So, even though James' life expectancy is approximately age 80 – that is a 50/50 proposition.

So, James' agent has discussed the idea of creating a "Legacy Floor" with him. Legacy Floor is a simple idea. While the terminology may be relatively new and the way it is presented may be new to some insurance professionals – Legacy Floor simply protects against early death. In our example, James anticipates growing his "savings" during the remainder of his lifetime to leave as a legacy to his heirs. What could derail his plan? James could not achieve his desired or expected growth rates on his assets. This could be a result of investment mistakes or simply an inopportune economic collapse. However, the biggest risk to James reaching his legacy goal is early death.

Using a modest portion of his current legacy portfolio (ie., the $2.5 million that James doesn't anticipate needing during lifetime ~~and his~~ considers his legacy portfolio), James can protect his heirs against James' early death. At age 60, a healthy male can purchase $2 million of permanent life insurance for approximately 1% of the $2.5 million legacy portfolio (i.e., $20,000 per year).

In addition to providing an immediate bump in James' legacy of $2 million, by purchasing insurance James has created a floor that could protect his heirs against untimely market downturns.

ESTATE TAXATION OF LIFE INSURANCE

Section 2042 Proceeds of Life Insurance.

Incidents of ownership – Any incidents of ownership in a policy held by decedent at the time of death will cause the proceeds to be included in his estate. The regulations under Section 2042 state that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. These rights include the power to: (1) the economic benefit of the policy, including the power to change the beneficiary; (2) surrender or cancel the policy; (3) assign the policy; (4) revoke an assignment; (5) pledge the policy for a loan; or (6) obtain a policy loan. However, direct or indirect payment of premiums is not an incident of ownership. See also, Life Insurance in Qualified Plans, pages 436-437.

Proceeds payable to estate – When proceeds are payable to or for the benefit of the deceased's estate they are subject to taxation in the insured's estate (e.g., when a trustee or third party is required to use the proceeds to pay estate taxes or other estate obligations).

Controlling stockholder – If the insured is a controlling stockholder and the corporation has any incidents of ownership in the policy, then proceeds paid to someone other than the corporation will be included in the estate of the insured. Under a split-dollar plan, an incident of ownership includes the right to borrow cash values (see expanded discussion and chart on page 362).

Fiduciary capacity – Under the regulations, an individual is considered to have an "incident of ownership" in an insurance policy on his life which is held in trust if he (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership of the policy or its proceeds, or the time or manner of enjoyment of the policy or its proceeds, even if he has no beneficial interest in the trust. It has been held that a co-trustee who has the right to elect a settlement option has a power to effect the time and manner of enjoyment of the policy proceeds insuring himself (i.e., he has an economic benefit). The courts are not consistent in their interpretation of the regulations ~~(see **Q 80** *Tax Facts on Insurance & Employee Benefits (2014)*)~~.

Section 2035 Transfers of Life Insurance.

Transfer of a policy by an insured within three years of his death will cause the proceeds to be included in his gross estate. It is not necessary that the insured have outright ownership of the policy, since transfer within three years of death of any of the above "incidents of ownership" is sufficient to cause the policy proceeds to be included in his estate.

(continued on next page)

ESTATE TAXATION OF LIFE INSURANCE (continued)

Under the pre-1982 versions of Section 2035, using a "beamed transfer" theory the courts found constructive transfers of life insurance policies by insureds within three years of death where: (1) the policy was purchased on the initiative of the insured; (2) the insured supplied the funds used to purchase the insurance; and (3) the insured died within three years of the purchase. However, after the change to Section 2035 in 1981, the courts have refused to extend this beamed transfer theory to insureds dying after 1981 (*Estate of Leder*, 10th Cir. 1989, *Estate of Headrick*, 6th Cir. 1990, and *Estate of Perry*, 5th Cir. 1991).

In July of 1991, the IRS issued an action on decision in which the Service announced that it would no longer litigate the issue of whether life insurance proceeds are includable in the insured's estate where the life insurance policy is procured by a third party at the instance of the insured, the insured pays the premiums, and the insured dies within three years of procurement of the policy by the third person (i.e., the "beamed transfer" theory). This means that the incidents of ownership in a policy on the decedent's life that is issued to a trustee of an irrevocable life insurance trust will not be imputed to the decedent by reason of the fact that the decedent initiated the procurement of the policy, paid the premiums, or filled out the application for the policy in his capacity as the prospective *insured* (as distinguished from the prospective *owner* of the policy).

Recommended method of purchase and ownership. Despite the Service's favorable decision, it is recommended that whenever possible: (1) a third party be the original applicant, owner, and premium payer; (2) premiums come from an account held in the name of someone other than the insured, i.e., a trustee or adult child; (3) gifts should not be in the same amount as the premiums; (4) the gifts should be made at times other than premium due dates; (5) the insured not be named trustee of an irrevocable trust which owns a policy on his life; and (6) split-dollar plans involving controlling stockholders should avoid giving the corporation any incidents of policy ownership (see page 362). See also, table of ownership and beneficiary arrangements, page 93.

Section 2036 Retained Life Estate.

Section 2037 Reversionary Interests.

Section 2038 Revocable Transfers.

Property given away is still included in the decedent's estate if he: (1) retained the income from, use or enjoyment of, or the right to designate who will ultimately receive the property or its income; or (2) had a reversionary interest worth more than 5 percent of the value of the property at his death, and the person to whom the gift was made could obtain possession or enjoyment only by surviving the decedent; or (3) reserved the power to alter, amend, revoke, or terminate the gift.

FAIR MARKET VALUE

Property included in a decedent's gross estate is valued at its fair market value on the date of the decedent's death or, if the executor elects, its fair market value 6 months after death (i.e., the "alternate valuation date"). Fair market value is defined in Treasury regulations as the price at which an item of property, or a business interest, would change hands between a willing buyer and a willing seller, neither of whom is under any compulsion to buy or sell, and both of whom have a reasonable knowledge of all the relevant facts.

When it comes to valuing an interest in a closely held business, the above definition of fair market value is often of little practical assistance. In Revenue Ruling 59-60, the Internal Revenue Service set forth the following eight factors that are considered essential in valuing a closely held corporation:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity.
6. Whether the enterprise has goodwill or other intangible value.
7. Sales of stock and the size of the block to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

It is interesting to note that factor number 6 is goodwill, and that four of the other factors play a part in the capitalization of earnings formula demonstrated in the chart on page 127.

In determining fair market value, discounts are allowed for minority interests and lack of marketability. For publicly traded stock, it is also possible to obtain discounts using the "blockage" theory, which recognizes that placing a large block of stock on the market would likely have a depressing effect on its price. However, a "control premium" might increase the stock value of a person owning more than 50 percent of the business.

FAMILY HOLDING COMPANY

The family holding company, or asset holding company, which is a method of recapitalization, should not be confused with the personal holding company. When a new family holding company is formed, it is authorized to issue both voting preferred stock and non-voting common stock. The business owner then transfers his common stock in the original operating corporation to the family holding company in exchange for the voting preferred stock and the non-voting common stock.

Traditionally, the intention is to "freeze" the interest of the business owner in the operating corporation by subsequent gifts of the non-voting common stock of the family holding company. Although gifts of family holding company stock would be subject to the impact of Chapter 14, the techniques used to reduce or avoid the effect of these valuation rules will also work with a family holding company (see pages 402-403, and **Q 777-Q 778**, *Tax Facts on Insurance & Employee Benefits (2015))*.

The problems with Section 306 stock do not exist with respect to the formation of the family holding company. A family holding company could become a personal holding company if it generates personal holding company income (i.e., passive income such as dividends, rents, and royalties). If there were personal holding company income, a distribution could avoid the personal holding company tax of 20 percent (as increased from 15 percent by the American Taxpayer Relief Act of 2012).

As with a recapitalization, there is a definite need to establish an accurate fair market value of the operating corporation prior to a transfer of its common stock to the family holding company.

FIDUCIARY

A fiduciary is an individual or organization who stands in a relationship of trust with another. The law imposes the highest standard of care upon fiduciaries, who must have complete loyalty to their principals in exercising their fiduciary duty. Attorneys, accountants, trust officers, physicians, registered investment advisers, trustees who manage money, and company directors and officers are all fiduciaries.

Under ERISA, a person who exercises discretionary control over plan management or plan assets, or regularly provides investment advice for a fee, is considered to be a fiduciary. When found to have exercised "functional control" over the plan's insurance decisions, life insurance salespersons have been held to be "inadvertent fiduciaries" under ERISA (e.g., when an unsophisticated fund trustee relies on the salesperson's advice as the primary basis for insurance decisions).

In contrast, as suggested by their state licenses, stock brokers and insurance sales agents who act only in a traditional sales capacity by limiting their advice to recommended purchases are typically considered salespersons, not fiduciaries. In declining to offer an opinion regarding an agent's alleged "fiduciary duty for recommending one policy over another," the State of New York Insurance Department has stated that: "the suitability of an insurance policy is a business decision for the insured to make based upon the insured's unique situation." However, under New York law, insurance agents and brokers are responsible in a fiduciary capacity for all funds received or collected from their customers.

Even if not a fiduciary, the agent or broker who undertakes to obtain insurance for a client owes a duty to exercise reasonable skill, care, and diligence in obtaining the coverage. Insurance agents and brokers can be held liable to their clients if they: (1) commit a fraud by either making a fraudulent statement or by withholding material information; (2) violate a state insurance code or other state statute; or (3) breach an express or implied contract; among other actions.

The line between *sales* activities and *fiduciary* activities is not always clear. Insurance producers who hold themselves out as professionals, with numerous credentials and high levels of expertise, may well be taking the first steps toward creating fiduciary relationships. It has been argued that fiduciary relationships are created when unsophisticated clients rely on these professionals for advice regarding complex insurance products and tax planning. If the facts and circumstances establish that fiduciary relationships exist, then these professionals will be held to fiduciary standards. Insurance professionals, particularly those holding themselves out as "financial planners," are well advised to maintain a high level of expertise through continuing study and education, and to further protect themselves with appropriate levels of errors and omissions insurance.

FINANCIAL UNDERWRITING

Underwriting is the process of risk selection. In addition to *medical* underwriting it is also important to consider *financial* underwriting, where the objective is to issue an amount of insurance that indemnifies but does not enrich the beneficiary.

The key to good financial underwriting is good communication and information. The more information that can be supplied the more likely that a case will be fairly and efficiently underwritten. Typically, the following kinds of information will be required: (1) sales proposals establishing reasons for the life insurance; (2) W-2 forms or latest income tax returns; (3) certified personal financial statements; (4) audited reports of assets, liabilities and operating income of the business; (5) business purchase agreements; and (6) letters of transmittal setting forth reasons for the insurance, details of the agent's knowledge of the applicant, and other pertinent information about the case.

When applying for life insurance it is important to be familiar with the insurance company's specific financial underwriting guidelines. Although different carriers may have similar guidelines, carriers will often differ in their published standards and the application of these standards.

Personal life insurance is intended to provide ongoing income to a surviving family by replacing human life value (see chart, page 15). The maximum amount is typically based upon the insured's age and annual *earned* income (but not including *unearned* income such as interest, dividends, rents and royalties). For example, between ages 50 and 54 the amount might be 8 times income, whereas between ages 20 and 30 the amount might be increased to 15 times income. These guidelines are sometimes exceeded when the proposed insured has a potential for substantially increased future income (e.g., the young medical intern).

Key person life insurance is intended to protect a business from the loss of technical and business talent and the resulting loss of profits (see chart, page 163). The amount of insurance is typically limited to some multiple of the insured's compensation (e.g., from three to ten times annual compensation). For a discussion of these formulas, see page 189.

Estate liquidity life insurance provides for final expenses, debts and estate taxes (see charts, pages 19, 23, and 25). Projections of liquidity needs at reasonable rates of estate growth for 5 to 10 years are often allowed (e.g., 8 percent growth over 10 years).

Buy/sell life insurance is issued to fund the purchase of a business interest. Determining the amount of insurance requires a consideration of the reasonableness of the value placed upon the business under the agreement. Insurance will likely be required on all owners, but not necessarily with the same carrier (see charts, pages 131, 135, 139, and 147).

FIRST-TO-DIE LIFE INSURANCE

First-to-die life insurance, also known as "joint life insurance," insures two or more lives, and pays a benefit upon the *first* death. Generally, the premium required for a permanent product is substantially less than those for individual policies on each insured.

Uses for first-to-die life insurance include: (1) income replacement in two wage-earner families (e.g., to pay off mortgage); (2) social security replacement for retirees; (3) estate tax payment to facilitate early transfer of appreciating assets to heirs; (4) key person insurance (chart, page 163); (5) funding split-dollar rollout of survivorship life insurance (page 558); and (6) funding both entity purchase and cross purchase agreements (charts, pages 131 and 135).

When funding a cross purchase agreement it is appropriate to have joint *ownership* of the contract. With equal ownership interests an appropriate *beneficiary* designation would be: "surviving insureds, equally." With unequal interests an appropriate designation would be: "surviving insureds as their interests may appear in the cross purchase agreement dated _____."

First-to-die life insurance is very effective in reducing the number of policies required to fund multiple-owner cross purchase agreements. For example, funding of a four stockholder cross purchase agreement requires twelve individual policies, but only four first-to-die policies (Options 1 and 2 below). A trusteed cross purchase agreement using an escrow agent requires four individual policies, but only one first-to-die policy (Option 3 that follows). If available, a survivor purchase option provides an effective means of acquiring ongoing insurance for surviving stockholders. Exercising this option appears to resolve the "transfer for value" problem caused by a transfer of policy interests following the death of a stockholder under a trusteed cross purchase agreement funded with individual policies (see footnote 8 on page 141, and pages 573-574).

However, first-to-die insurance has not proven to be commercially successful for insurance companies. Because the cost of a first-to-die policy is not always materially less expensive than two individual policies (assuming a two life application), the use of first-to-die product is not as common as might be expected. For this reason, it is increasingly difficult to find life insurance companies that issue this product.

OPTION 1	Owner ⟶	**A**	**B**	**C**	**D**
	12 individual policies insuring	B C D	A C D	A B D	A B C
OPTION 2	Owner ⟶	**A**	**B**	**C**	**D**
	4 first-to-die policies insuring	B C D	A C D	A B D	A B C
OPTION 3	Owner ⟶	**ESCROW AGENT**			
	1 first-to-die policy insuring	A B C D			

FUNERAL TRUSTS

A funeral trust is an arrangement under which an individual, during his lifetime, purchases funeral services or merchandise from the provider of funeral and burial services. Pursuant to a contract between the individual and the provider, the individual selects the services and merchandise to be provided at death and agrees to make payments during lifetime into a trust.

A "qualified funeral trust" is a trust arising out of a contract with a person in the business of providing funeral or burial services, the sole purpose of which is to hold, invest, and reinvest funds in the trust and to use such funds to make payments for the funeral or burial services of beneficiaries under the trust. Contributions to the trust can only be made for the benefit of beneficiaries. There are no dollar limit on contributions to funeral trusts. Contributions to the trust are not deductible for income tax purposes. However, the trustee of the trust can elect to have the trust earnings taxed to the trust and payable by the trustee (i.e., elect exemption from the grantor trust rules that would cause trust income to be taxed to the grantor). Each beneficiary's interest is treated as a separate trust for this purpose. However, a qualified funeral trust is not allowed a personal exemption.

GOLDEN PARACHUTE RULES

Under these rules, a corporation is barred from taking an income tax deduction for an "excess parachute payment" made to an officer, shareholder, or highly compensated individual when the payment is contingent upon a change in ownership or control of the corporation. In addition, a nondeductible 20 percent excise tax is imposed on the employee's excess payment.

Parachute payments are generally defined as any payments in the nature of compensation, which are contingent upon a change of ownership or effective control of the corporation when the present value of such payments equals or exceeds three times the individual's average annual compensation in the five taxable years ending before the date of the change. If the individual has been employed by the corporation for fewer than five years, then average annual compensation is determined by using the years actually employed.

These rules can adversely impact a *supplemental* deferred compensation plan if the plan calls for an acceleration of vesting or payment of benefits due to a change in control. However, these rules do not impact a pure *deferral* plan under which the executive has made an election to actually defer income previously earned. There are also limited exceptions for payments made by closely held corporations.

The golden parachute rules should not be confused with the $1,000,000 compensation deduction limitation placed upon publicly held corporations (i.e., those that issue stock required to be registered under the Securities Exchange Act of 1934). Under this limitation, such corporations may not deduct compensation in excess of $1,000,000 paid to the chief executive officer and the four highest paid officers of the corporation. In effect, this limitation declares such excess compensation to be unreasonable per se, and therefore not deductible. Both split-dollar and executive bonus plans for this group of executives could be impacted. However, excluded from the limitation are: (1) amounts paid by reason of worker's compensation, medical or hospitalization expenses, or payments made to any qualified plan or SEP; (2) commission payments; (3) performance-based compensation meeting strict qualifications and standards; and (4) stock options and stock appreciation rights. A $500,000 compensation deduction limit applies to executives of employers who sold assets to the Troubled Asset Relief Program and employees of certain health insurers or service providers (after 2012).

GRANTOR TRUST RULES

Under the grantor trust rules, a grantor who retains interests in a trust created by the grantor may be treated for income tax purposes as the owner of all or part of the trust and thus taxed on all or a portion of the trust income. Retention of the following powers or interests, among other powers, can cause a trust to be considered a grantor trust: (1) reversionary interests in the income or principal of any portion of a trust that exceed five percent of the value of the trust; (2) the power to control the beneficial enjoyment of any portion of the trust that can be exercised without the approval of an adverse party (excepted is the power to limit distributions of principal to a beneficiary using a "reasonable definite standard"); (3) administrative powers, including the power to deal with trust funds for less than full and adequate consideration and to borrow without adequate interest or security; (4) power to revoke the trust; and (5) income of the trust is *or may be* distributed to or held for the future use of the grantor or the grantor's spouse, used to discharge a legal obligation of the grantor, or used to purchase life insurance on the life of the grantor or the grantor's spouse.

Thus, transfer of income-producing property to a trust and the subsequent use of that income to pay life insurance premiums will result in the income being taxed to the grantor. The results are less clear when a trust merely authorizes the payment of premiums from trust income but does not use trust income for this purpose. In order to avoid grantor trust status, most authorities recommend that the trust language specifically prohibit the use of trust income to pay life insurance premiums on the life of the grantor or the grantor's spouse. To insure grantor trust status when considered beneficial for planning purposes, many attorneys favor use of the power to substitute assets of equal value as a grantor trust power.

A "defective" trust is an *irrevocable* trust that intentionally violates one or more or the grantor trust rules (see chart, page 67). With a defective trust, application of the grantor trust rules can work to the taxpayer's advantage: (1) *To transfer additional amounts to trust beneficiaries without gift tax consequences*. Income taxes paid by the grantor on trust income distributed to beneficiaries may not be included in the value of gifts made by the grantor. (2) *To avoid the transfer for value rules*. A grantor trust that is taxed as if owned by the grantor/insured can purchase or obtain existing policies on the grantor's life without adverse tax consequences (i.e., the transaction falls within the "transfer to the insured" exception, see page 573). (3) *To avoid disqualification of the S corporation election*. An irrevocable grantor trust can be a stockholder, but limited to two years after the grantor's death.

Some, but not all, grantor trust powers also cause estate tax inclusion. Hence, when doing estate planning for taxable estates it is important that any powers or interests retained by the grantor not cause the trust to be included in the grantor's taxable estate. Clearly, application of the grantor trust rules can be very complicated and the advice of competent tax counsel should always be sought.

GRITs, GRUTs, AND GRATs

GRITs. Prior to the changes brought about by the special valuation rules of Chapter 14, a grantor retained *income* trust (GRIT) was an effective technique for transferring property between generations. For example, a GRIT was created by having a grantor establish an irrevocable trust from which he retained the right to trust income for a specified period. At the end of this period, the succeeding trust beneficiaries (or remainderpersons) received the trust principal. Because of the reserved income interest, the gift tax value of the transferred remainder interest was usually substantially less than the current value of the property. However, except for a personal residence, for most taxpayers, Chapter 14 effectively eliminated the GRIT as a viable estate planning tool, since the grantor's right to trust income is deemed to have no value, meaning that the gift tax value of the remainder interest is equal to the *entire* value of the trust property (see pages 402-403). The gift tax cost is exactly the same as if the grantor had made a direct gift of the property to the remainderpersons. In place of a GRIT, the grantor retained unitrust (GRUT) and the grantor retained *annuity* trust (GRAT) are available to leverage gifts between generations.

GRUTs. The GRUT is an irrevocable trust in which the grantor retains the right to receive a *fixed percentage* of the trust's assets payable at least annually for life or for a term of years (and which must be revalued annually). However, in contrast to the GRAT, the GRUT will provide increasing payments to the grantor if the value of the trust increases (or decreasing payments if the value of the trust decreases). The GRUT is actuarially similar to the charitable remainder unitrust (see page 54).

GRATs. The GRAT is an irrevocable trust in which the grantor retains the right to receive *fixed payments* payable at least annually for life or for a term of years (see chart, page 59). In contrast to the GRIT, the GRAT *must pay* a fixed annual payment to the grantor, regardless of the income earned (whereas the GRIT often experienced substantial appreciation while yielding only a modest income). The GRAT is actuarially similar to the charitable remainder annuity trust (see page 54).

With both the GRAT and the GRUT, the value of the transferred remainder interest is equal to the present value of the entire property reduced by the present value of the retained interest. If the grantor is seeking to reduce his estate, additional smaller gifts that qualify for the annual exclusion can be made with the funds provided by trust payments. See the discussion of recessionary estate planning on pages 522-523.

GROUP CARVE OUT

The term "group carve out" is often used to describe the *replacement* of group term insurance for a selected class of executives with individual permanent insurance policies. Increased popularity of this concept has been due to the prohibition against individual selection in providing amounts of coverage to key employees.

Although a variety of plans are used to fund a group carve out, the more popular include Executive Equity (see chart, page 217) and Split-Dollar Insurance (see chart, page 225). The advantages of group carve outs include: (1) the provision of permanent post retirement insurance for the executive; (2) lower long term cost for the employer; (3) elimination of the increasing term cost after retirement to both the executive and the employer; (4) flexible structure with no ERISA or nondiscrimination requirements; (5) cost recovery options for the employer; and (6) portability of the policy for the executive.

The design of individual illustrations will differ widely depending upon the circumstances of the existing group program and the proposed method of funding the group carve out. However, it is essential to compare annual costs to both the employer and executive, both before and after the carve out. This includes estimates of the current and projected group premiums for the executive's coverage under the group plan, together with the after-tax costs of bonuses, if any, given the executive to cover his tax cost of amounts of coverage in excess of $50,000. These same employer after-tax dollars are then placed in an executive equity or split-dollar program. Should the group carve out plan require additional executive costs (i.e., either direct premium payments or increased tax costs), then it is important to make a direct year-by-year comparison of this cost to the executive's ownership of policy cash values.

GUARANTEED MINIMUM WITHDRAWAL BENEFIT

When an annuity is annuitized, the owner loses all control over the underlying funds, has no right to make investment decisions, and gives up any rights to accelerated payments. The owner's only right is to receive the periodic payments as stipulated in the contract. The guaranteed minimum withdrawal benefit (GMWB) is a variable annuity living benefit that allows the contract owner to retain control.

The GMWB guarantees the contract owner can withdraw each year a fixed percentage of the premiums, *until all premiums have been completely recovered*, regardless of the actual account value. The amount against which this percentage is applied is variously referred to as the total premiums, the principal, the protected value, or the benefit base. Although annual withdrawals can be stopped and started at any time, failure to make a withdrawal does not entitle the contract owner to subsequently recover the amount not withdrawn. If a withdrawal in any one year exceeds the guaranteed percentage, the benefit base can be reset, which in a declining market could result in a lower guaranteed payment (i.e., same percentage applied to a lower benefit base). The contract can be surrendered at any time, provided the underlying funds are positive (i.e., a form of liquidity guarantee). The GMWB addresses the fear of losing control, but it does nothing to protect the contract owner from running out of money.

The GMWB "for life," or guaranteed lifetime withdrawal benefit (GLWB), addresses the fear of running out of money. Whereas the GMWB is essentially a money-back guarantee for the original premium, the GLWB guarantees a lifetime of income, regardless of the performance of the underlying funds (both single and joint spousal lifetime withdrawal options are available). In order to control risk, the owner is contractually limited as to the types of investments in the annuity subaccounts. A "step-up," or "ratchet-up," feature in many contracts allow the withdrawal amount to be increased on specified contract anniversaries, provided the actual account value is higher than the benefit base. Withdrawing more than the annual guaranteed percentage will generally void the lifetime guarantee.

Although the GLWB guarantees an income stream that may appear similar to annuitization, there are substantial differences between withdrawals and annuitization. For example, *withdrawals* from an annuity are first taxed at ordinary income tax rates on any growth within the annuity (first-in last-out), whereas when a contract is *annuitized*, use of an exclusion ratio allows a portion of each payment to escape taxation as a return of principal.

It is important to recognize that the "guarantees" offered by these living benefits (GMWB and GLWB) are subject to the claims-paying ability of the issuing life insurance company (i.e., guaranteed may not *really* mean guaranteed). See Life Insurance Default Risk, page 435. The evolving nature and variety of contract provisions make these complex products. This makes it essential that the agent fully understand the product and the purchaser carefully read the prospectus.

GUARANTEED PURCHASE OPTION

At the time a life insurance policy is issued it is sometimes possible to purchase an option that provides the policy owner with the right to purchase, without evidence of insurability, additional amounts of permanent insurance at stated intervals or upon stated events. This option is usually issued as a rider to the basic policy and terminates at a specified policy anniversary. Some options provide an overall limit on the amount of additional insurance that may be purchased. Premiums for the option are based upon the insured's attained age and are payable until the rider terminates. Guaranteed purchase options are also referred to as "insurability options." Use of a guaranteed purchase option is particularly attractive when insurance is issued on the life of a child (see the discussion of children's life insurance on page 350).

When the option is exercised the insurance purchased does not have to be the same plan as the basic policy. Premiums for the additional insurance are sometimes offered at the same underwriting class as the initial coverage (locking in today's health) and sometimes at standard rates (creating a hedge against future health deterioration). For example, a typical rider might provide for the option to purchase $20,000 of additional insurance every three years until the policy anniversary nearest the insured's age 40. Additional option dates might also include the insured's marriage and the birth of each of the insured's children.

Other forms of guaranteed purchase options offer guaranteed insurance under cost-of-living adjustments that are tied to increases in an economic inflation indicator, such as the Consumer Price Index. Another variation, known as a "beneficiary purchase option," allows the beneficiary, upon the death of the insured, to elect to use part or all of the proceeds to purchase insurance without evidence of insurability. However, at the time the underlying policy is issued the beneficiary must prove insurability. This option is used as a substitute for survivorship life insurance and may offer greater flexibility (i.e., the surviving spouse uses some of the proceeds to pay estate taxes at the first death and the remaining proceeds to exercise the "last to die" option). Still another variation, known as a "surviving spouse option," is used with survivorship insurance (see the discussion of survivorship life insurance on page 566). This option allows the policy owner to purchase an additional amount of insurance on the primary insured following the death of his or her spouse.

HEALTH CARE POWER OF ATTORNEY

A health care power of attorney is a document that allows an individual to designate another person to make health care decisions when the individual is unconscious or mentally incompetent. The powers given include the power to consent to the giving, withholding, or stopping of medical treatment, service, or diagnostic procedures, including the withdrawal of life support. (The privacy rules of the Health Insurance Portability and Accountability Act of 1996, or HIPAA, make it important that the power-holder also be given the right to obtain and review medical records.) The power does not become effective until the individual has been declared by an attending physician to be incapacitated. In order to avoid conflicts between power-holders, it is best that only one power-holder be appointed at a time, but successor power-holders should be named. In general, a subsequent marriage automatically revokes a health care power of attorney held by someone other than the new spouse. Likewise, a subsequent divorce or separation usually revokes a health care power of attorney held by the divorced or estranged spouse. While there may be slight distinctions from state to state, the health care power of attorney is also referred to as a:

- Durable Power Of Attorney For Health Care
- Medical Power Of Attorney
- Health Care Proxy
- Health Care Surrogate Designation

In various ways, virtually all states recognize the right of a person to designate another person to make end-of-life choices for them in case of their mental incapacity. Other documents used for these purposes include:

1. **Living Wills** that merely express individuals' wishes with regard to life-sustaining procedures. They do not appoint another person to make specific health care decisions (see page 468).
2. **Advanced Health Care Directives** that provide instructions as to what should be done if grantors are unable to make future health care decisions. Health care power of attorneys and living wills are both considered to be advanced health care directives (AHCDs). In some states, documents referred to as AHCDs contain elements of both the health care power of attorney and the living will.
3. **Medical Directives** that contain elements of both the health care power of attorney and the living will, by allowing individuals to state their wishes regarding various types of specific medical treatments, appoint a proxy, and record wishes regarding organ donation (see www.caringinfo.org).

Because of potential differences between states, it is strongly recommended that individual state laws be consulted.

INCENTIVE STOCK OPTION

The incentive stock option (or "ISO"), also known as a qualified or statutory stock option, is an employee benefit used to attract and retain key corporate employees. Provided the required holding period is met, the employee is not taxed at the time the option is exercised and receives favorable capital gains treatment on the sale of the stock. In contrast to the incentive stock option, with the nonqualified stock option (also referred to as a non-statutory stock option) the employee is generally taxed at the time the option is exercised and does not receive favorable capital gains treatment. However, due to the required holding periods, the holder of the incentive stock option assumes more risk than the holder of the nonqualified stock option.

An incentive stock option must: (1) be granted under a plan that sets forth the number of shares to be issued and the employees or class or employees to receive the option; (2) be granted under a plan that is approved by the stockholders within 12 months before or after the plan is adopted; (3) be granted within 10 years after the plan is adopted or approved by the stockholders, whichever comes first; (4) be exercisable within 10 years after it is granted; (5) have an exercise price that is not less than the fair market value of the stock at the time it is granted; (6) be non-transferable and exercisable only by the transferee (except that it may be transferred by will or the laws of descent and distribution); and (7) be granted only to an employee who owns no more than 10 percent of the voting stock of the corporation (an exception applies when the option price is at least 110 percent of the fair market value of the stock).

Provided the employee does not sell the stock until at least a year and a day after the stock is purchased (option exercised) and at least two years after the option is granted, any profit on the sale is treated as long-term capital gain. For example, assume the employee is granted an option to purchase 100 shares at $75.00 per share on April 5, 2015 (stock has a fair market value of $74.00; thus exercise price is not less than the fair market value). The employee then uses part of his year-end bonus to exercise the option on February 15, 2016 and purchases 100 shares at $75.00 per share. Waiting until February 16, 2017 to sell the stock will comply with the *over one-year-after-purchase* holding period, but it would not comply with the *at least two-year-after-grant* holding period. The employee needs to wait until April 5, 2017 to sell the stock in order to received capital gains treatment. If the stock had a value of $86.00 on the day option was exercised (February 15, 2016) the difference between that value and the grant price of $75.00 is referred to as the bargain element. In this case the total bargain element would be $1,100 (86 – 75 = 11 × 100 = 1,100). In the year the option is exercised this bargain element must be reported as taxable compensation for alternative minimum tax (AMT) purposes (but Congress has provided some specific relief for taxpayers with incentive stock options).For additional information, see **Q 7542-Q 7549**, *Tax Facts on Investments (2015)*.

INCENTIVE TRUST

The dilemma faced by many wealthy individuals is how to pass down the family fortune without taking away their children's ambition, drive, and willingness to lead productive lives. Recent creation of substantial wealth in the stock market and the large inheritances being passed to today's "baby boomers" has only added to the number of families facing the challenge of "financial parenting." The incentive trust is a response to these concerns.

In contrast to the traditional trust, with its set distribution times and amounts, the incentive trust goes beyond the age-linked distribution formulas by attaching conditions to distributions. For example, the incentive trust might contain provisions that tie the timing and size of distributions to the achievement of certain goals by the beneficiaries, such as receipt of good grades, graduation from college, obtaining a graduate degree, a first job, or the attainment of specific levels of income. More controlling provisions might reward certain conduct or community service, such as staying at home to take care of children, serving as a missionary, or remaining alcohol or drug free (i.e., "tough love" when there has been a prior history of abuse).

The potentially restrictive and controlling nature of such trusts is a matter of some debate. To some, incentive trusts might be seen as nothing more than an attempt to unduly "control from the grave." Yet it seems most laudable when parents desire to teach their children to be good stewards of family wealth. Establishing such a values-oriented trust will likely require a great deal more thought and effort then is required of the typical tax-savings and distribution trust (see charts on pages 25 and 51).

When creating an incentive trust, a "one size fits all" approach is not appropriate. Ideally, the trust will accomplish the grantor's objectives without unduly restricting the trustee's ability to respond to changing circumstances, such as a beneficiary's marriage, medical emergency, or behavior. A good trust must be carefully drafted. While encouraging positive social goals and distributing income, the trust should also act as an economic safety net for children and other heirs.

Use of an institutional trustee together with an individual co-trustee who is either a family member or friend will avoid the undue pressure that can be placed on an individual trustee by beneficiaries demanding distributions that are inconsistent with trust objectives. It also seems quite reasonable to include provisions for the replacement of an unsatisfactory trustee by the beneficiaries.

In addition to the incentive trust, private foundations are also used as a means of involving children and other heirs in the responsible charitable distribution of a family's wealth.

INCOME IN RESPECT OF A DECEDENT

The term "income in respect of a decedent" (IRD) refers to those amounts which a decedent was entitled to as gross income, but which were not includable in his taxable income for the year of his death. For example, the following are considered IRD: (1) payments to a surviving spouse under an individual deferred compensation agreement; (2) compensation for services rendered before death; (3) renewal commissions of a life insurance agent; (4) dividends declared but unpaid to a stockholder prior to his death; (5) interest owed the decedent at the time of his death; (6) the decedent's distributive share of partnership income; (7) amounts paid for unrealized receivables upon the sale or liquidation of a partnership interest; (8) distributions from a 403(b) plan; (9) distributions from a decedent's individual retirement account; and (10) proceeds from sales on the installment method.

It is important to recognize that, unlike other property included in an estate, the recipient of IRD does not receive a stepped-up basis for the purpose of computing gain or loss (see the discussion of stepped-up basis on page 561). Thus, the estate or beneficiary who receives IRD will pay tax on that income in the same manner as the decedent. If the income would have been ordinary income to the decedent, then it is ordinary income to the estate or beneficiary. Likewise, if the income would have been treated as capital gains to the decedent, then it is treated as capital gains to the estate or beneficiary.

However, an income tax deduction is available which somewhat (albeit not entirely) alleviates this "double" taxation (i.e., subjecting the IRD to both estate taxation and income taxation). The recipient of IRD generally may take an income tax deduction for any estate taxes paid by the estate on the IRD. The amount of the deduction is determined by comparing the actual estate tax paid with the amount of estate tax that would have been paid had the IRD asset not been included in the estate (i.e., the deduction is determined at the highest estate tax rates to which the estate was subject). The deduction can also be taken for generation-skipping taxes paid on the IRD asset. This is a *deduction* to be used in determining the income taxes of the estate or beneficiary receiving the IRD, it is not a *credit* against the income tax due.

INDIVIDUAL 401(k) PLAN

Also referred to as a "Solo 401(k) Plan," the Individual 401(k) Plan is a regular 401(k) plan combined with a single-participant profit sharing plan (the name itself has been created by the marketplace; it is not found in the Code). Individual 401(k) Plans are limited to self-employed individuals or small business owners who have no other full-time employees (an exception allows coverage of both the self-employed individual or business owner and his or her spouse who is employed full time).

Individual 401(k) Plans can provide for increased retirement contributions without many of the complex administrative rules and nondiscrimination testing required of 401(k) plans and profit sharing plans covering multiple employees. (Should the sponsoring employer add additional employees to the plan, it is subject to the same minimum participation, coverage, nondiscrimination, and other requirements that apply to any other qualified defined contribution plan.) Other advantages include availability of loans, year-to-year contribution flexibility, availability of hardship withdrawals, rollovers from other retirement arrangements, and the ability to purchase permanent life insurance (see pages 436-437).

In 2015, the Individual 401(k) Plan contribution limit is effectively the lesser of 100 percent of compensation or $53,000 ($59,000 if age 50 or over). Annual contributions to an Individual 401(k) Plan consist of two parts: a tax deductible salary deferral contribution plus an additional tax deductible profit sharing contribution:

1. Salary Deferral Contribution. In ~~201~~, 100 percent of compensation up to a maximum of $18,000, or $24,000 if age 50 or older ($18,000 plus $6,000 catch-up), can be contributed in salary deferrals. For S and C corporations compensation is based on W-2 wages. For businesses taxed as sole proprietorships and partnerships compensation is based on net earnings (net profit less the deduction taken for one-half of the self-employment tax).

2. Profit Sharing Contribution. For S and C corporations profit sharing contributions can be made up to 25 percent of W-2 wages. For sole proprietorships and partnerships profit sharing contributions can be made up to 20 percent of net earnings.

The sum of the salary deferral and profit sharing contributions cannot exceed the 2015 Individual 401(k) Plan contribution limit. For example, a self-employed individual age 45 (limit of $53,000) doing business as a sole proprietor and having $100,000 in net earnings can contribute $38,000 ($18,000 of salary deferrals plus 20 percent of $100,000 in net earnings). Likewise, a self-employed individual age 52 (limit of $59,000) doing business as an S corporation and having $100,000 in W-2 wages can contribute $49,000 ($24,000 of salary deferrals plus 25 percent of $100,000 in W-2 wages). Deferral contributions reduce taxable W-2 wages (or net earnings) and profit sharing contributions are generally tax deductible as a business expense. See also, simplified employee pension (SEP) on page 555.

INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)

There are two types of regular individual retirement arrangements, individual retirement accounts and individual retirement annuities. Each is often referred to as an "IRA" (see also pages 311-312, 535, and 572). Generally an individual retirement *account* is set up as a trust or custodial account with a bank, a federally insured credit union, or a savings and loan association, whereas an individual retirement *annuity* is established by purchasing an annuity contract from a life insurance company. Life insurance may not be purchased by the IRA.

Contributions may be made up to the time when the individual's tax return is due (excluding extensions). In order to deduct contributions an individual must: (1) have compensation (including earned income as an employee or self-employed person, or alimony); and (2) not have attained age 70½ during the taxable year for which the contribution is made.

In 2015 a deduction may be taken for amounts contributed up to the lesser of $5,500 or 100 percent of compensation includable in gross income. An additional "catch-up" contribution of $1,000 is allowed in 2015 for individuals who attain age 50 before the close of the taxable year. Deductions may be reduced or eliminated if the individual is an "active participant" in a qualified plan. In 2015 the phase-out range for a *married couple filing jointly* is between $183,000 and $193,000 for a spouse who is not an active participant and between $98,000 and $118,000 for a spouse who is an active participant. The phase-out range for a *single individual* who is an active participant is between $61,000 and $71,000. Similar deductions may be taken for contributions to the IRA of a lesser-compensated spouse.

Generally, funds accumulated in a plan are not taxable until they are actually distributed. However, amounts distributed prior to age 59½ are considered early distributions and are subject to a 10-percent-penalty tax. Exceptions to the penalty tax include distributions: (1) made on or after death; (2) attributable to disability; (3) which are part of a series of substantially equal periodic payments made (at least annually) for the life or life expectancy of the individual or the joint lives or joint life expectancy of the individual and a designated beneficiary (e.g., an annuity payout); (4) for medical expenses in excess of 7.5 percent of adjusted gross income; (5) for health insurance premiums for those receiving unemployment compensation; (6) to pay for a first home; or (7) to pay for qualified higher education expenses. Distributions from a plan must usually begin by April 1 of the year after the year in which the individual reaches age 70½.

In order to prevent current taxation IRAs are frequently used for "rollovers" of distributions from qualified plans, 403(b) plans, or eligible 457 government plans. An IRA that meets certain requirements may accept an expanded rate of contribution as a simplified employee pension (SEP). SEPs are discussed on page 555.

INSTALLMENT SALE

An installment sale provides a method by which the gain on the sale of property, and the income tax on that gain, can be spread over a period of time. No payment is required in the year of sale; the only requirement is that at least one payment be made in a taxable year after the year of the sale. Payments can be tailored to fit both the seller's income and tax requirements, since gain and the payment of tax on that gain is prorated according to the amount received each year.

When there is a sale between related parties (spouses, children, etc.), any resale by the buyer within 2 years accelerates the gain to the seller unless such resale occurs after the death of either of the related parties. The seller's gain will also be accelerated if the seller cancels the buyer's obligation (this may also include a cancellation by bequest or by the seller's executor). However, it appears that this technique of making gifts is available with an installment sale, provided there is a forgiving of each installment payment as it comes due. See the expanded discussion of self-cancelling installment notes, page 550.

If the amount of debt does not exceed $5,468,200 (as adjusted in 2015 for inflation) and the installment sale does not provide for a *minimum* interest rate equal to the "applicable federal rate," the IRS will generally impute an interest rate at the lower of the applicable federal rate or 9 percent, compounded semiannually. However, with intra-family aggregate sales of land of not more than $500,000 during a calendar year, the imputed interest rate would be the lower of the applicable federal rate or 6 percent. Applicable federal rates are determined by the Secretary of the Treasury on a monthly basis (for this purpose it is the lowest rate in effect during the 3-month period ending with the month in which there is a written contract).

Unless it can be shown that avoidance of income tax was not a principal purpose, the sale of *depreciable property* to a controlled entity may not be reported on the installment basis. Accrual method taxpayers generally may once again use the installment method for sales or other dispositions retroactive to December 17, 1999 (except in the case of property used in the trade or business of farming, timeshares, and residential lots).

INSURABLE INTEREST

The issuance of an insurance contract to someone who does not have an insurable interest in the life of the insured is, as a matter of public policy, depending upon the jurisdiction, either void or voidable by the carrier who issued the policy. Generally stated, an insurable interest arises from the relation of the party obtaining the insurance to the insured, provided there is a reasonable expectation of advantage or benefit from the continuance of the insured's life. An insurable interest is based upon relationships which involve: (1) pecuniary or economic advantage through the continued life of the insured or loss by reason of his death; or (2) love and affection in case of individuals closely related by blood or marriage.

The following are generally considered to have insurable interests: (1) a person on his own life; (2) a wife in her husband's life and a husband in his wife's life; (3) a fiancée in her fiancé's life and a fiancée in his fiancée's life; (4) a parent on a minor child's life (but not necessarily on an adult child's life); (5) a creditor in the life of his debtor; (6) an employer in the life of a key employee (but not a rank and file employee); (7) each of the partners, and the partnership itself, in the life of a partner whose death would result in a substantial loss; (8) each of the partners to a buy/sell agreement in the life of another partner, provided the beneficiaries do not stand to gain upon the death of the insured; and (9) among stockholders in a closely held corporation to the extent, and on the same basis, that an insurable interest exists among partners. See page 346 regarding charities having an insurable interest in the lives of donors.

Provided the insurable interest requirements are satisfied at the inception of the contract, in virtually all states a policy remains valid thereafter even if at the insured's death the policy owner-beneficiary no longer has an insurable interest. In recent years, there has been considerable litigation pertaining to insurable interest. In many states, it appears unlikely that insurable interest will be respected when the original legal owner had insurable interest but an arrangement was already in place to transfer the poliicy after issue to someone lacking insurable interest. The original insurable interest must be more than a mere formality or the court may look to the substance of the transaction rather than the mere form.

If the applicant has no insurable interest at the time a policy is taken out, the proceeds will be taxed as gain from a wagering contract. Since the existence of an insurable interest is governed by the case and statutory law of each state, it is essential to refer to these specific state laws for answers to questions regarding an insurable interest.

See Stranger-Originated Life Insurance (STOLI), page 563, for a discussion of the controversy surrounding using otherwise valid insurable interest of a charity for the benefit of third-party investors without insurable interest.

INTEREST ADJUSTED NET COST

Net Cost Method. Prior to introduction of the interest adjusted net cost method, the cost of life insurance was frequently determined by the "net cost" method, which consisted of simply adding up the net premiums (premiums less dividends), subtracting out any cash values, dividing by the number of years, and then dividing by the number of thousands of insurance. For example, assume a $150,000 nonparticipating contract with premiums of $900 per year yields $6,000 of cash values in the 10th year:

Premiums per year	900
Number of years	x 10
Total premiums paid	9,000
Less cash values	(6,000)
	3,000
Number of years	÷ 10
Cost per year	300
Number of thousands	÷ 150
Cost per year per thousand	2.00

Interest Adjusted Net Cost Method. But the above calculation fails to account for the time value of money. The *interest adjusted* net cost (IANC) method has been adopted by most states in order to provide some index for comparing one life insurance contract with another, and is particularly useful where there is a difference in amount and timing of premiums, availability of dividends, and amounts of cash values. The IANC method assumes that the purchaser would be helped by comparing the results of his purchase to those that he could obtain by investing his money in a 5 percent savings account, with interest compounded annually. The basic question involves determining what amount of annual deposit would be required to end up with the same cash accumulation. Assuming the same $150,000 nonparticipating contract:

Life Insurance Contract		
Premiums per year		900.00
Cash values in 10 years	6,000	
5% Savings Account		
Cash value objective	6,000	
Future Value factor (table, page 598)	÷ 13.207	
Annual deposit required		(454.30)
Cost per year for insurance		445.70
Number of thousands of coverage		÷ 150
Cost per year per thousand		2.97

INTEREST DEDUCTION

The deductibility of interest depends on its classification. For example, *investment interest* is generally deductible only to the extent of investment income, *qualified residence interest* is generally deductible in full, *trade or business interest* is generally deductible as a business expense, and *personal interest* is not deductible at all (except student loan interest; see page 352).

Personal interest includes interest on personal loans and interest on personal life insurance policy loans used to pay premiums on the policy. Investment interest may be deducted to the extent of net investment income. There are no limitations on deductibility of interest on amounts borrowed for ordinary and necessary business purposes.

Thus, loans used to purchase a personal life insurance policy or loans used to carry a personal life insurance policy are not deductible.

INTEREST-FREE LOANS

At one time the use of interest-free, or below market, loans between parent and child, or employer and employee, was generally considered an effective means of transferring income that offered many tax advantages. The Supreme Court decision in *Dickman*, the introduction of the concept of "forgone interest," and the phasing out of the deduction for personal interest limited these tax advantages. Nevertheless, there may still be circumstances in which such loans would be appropriate to accomplishing nontax objectives (parent loans to child to buy life insurance, or corporation loans to nonstockholder-employee as a form of "golden handcuffs").

Gift Loans. When a below market or term loan is treated as a "gift loan" the lender is deemed to have transferred (imputed gift) to the borrower, and the borrower is deemed to have retransferred (imputed payment) to the lender, an amount equal to the foregone interest. The effect of this retransfer is that the foregone interest is included in the gross income of the lender, and the borrower is considered as having paid the interest (for individuals, there is no deduction for personal interest, as discussed on page 428) and the lender will have interest income.

Compensation-Related Loans. The same transfer and retransfer of foregone interest is deemed to have occurred with loans between employers and employees, or corporations and stockholders, as with gift-loans. The employer will be deemed to have interest income in the amount of the foregone interest, which would be offset by a corresponding deduction for compensation paid (if reasonable). The employee will have taxable income and is considered as having paid the interest. However, with stockholder-employees, the foregone interest will be treated as a nondeductible dividend payment. The Sarbanes-Oxley Act of 2002 adopted new securities law provisions that prohibit below-market loans made by a *public* corporation to its executives. Note in this regard the split-dollar regulations that consider some split-dollar arrangements as employee-loans subject to deemed loan and imputed interest treatment (see pages 395-396).

Exceptions. There is a $10,000 de minimis exception for compensation-related or corporation-stockholder loans that do not have tax avoidance as a principal purpose. Another exception is available when the total loans between individuals (husband and wife are considered one individual) do not exceed $10,000 unless the gift loans are directly attributable to the purchase or carrying of income-producing assets. These exceptions may protect low interest loans used to purchase life insurance, unless the life insurance is considered an income-producing asset in the case of a gift loan, or there is a tax avoidance purpose in the case of a corporation-employee or corporation-stockholder loan.

Low Interest Rate Loans. However, while interest-free loans are generally not allowable, today's low interest rate environment lends itself to use of loans as a planning tool. One of the more common estate planning transactions today is the sale of assets to an "intentionally defective trust" using loans at the "applicable federal rate ('AFR')." The short-term AFR (for demand loans and loans less than 3 years in length) was only 0.38% in October, 2014. See a discussion of Intentially Defective Trust planning on page 66.

IRA DISTRIBUTION PLANNING

Funds cannot be kept in an IRA indefinitely. Eventually they must be distributed. Effective distribution planning requires a careful consideration of both tax and nontax issues. The first and most important consideration should be the owner's need for income. If funds are required before age 59½, the early distribution penalty tax must be avoided. If funds are left to accumulate after age 70½, the 50 percent excise tax on undistributed minimum required distributions must be avoided. And finally, selection of beneficiaries not only determines those individuals who will inherit the IRA, but how and when the IRA will be subject to income taxation.

Early Distribution Penalty Tax

Distributions prior to the owner's age 59½ are subject to an additional 10 percent early distribution penalty tax, unless an exception applies (see pages 424 and 543). With a SIMPLE IRA, early distributions within two years of beginning participation are subject to a 25 percent penalty tax (see page 554). Beneficiaries of inherited IRAs are not subject to this tax.

Required Minimum Distributions

Distributions that are less than the required minimum are subject to a 50 percent excise tax (i.e., it is levied on any amount not distributed as required). The amount and timing of these distributions will vary, and is dependent upon a number of factors, including the attained age of the owner, when the owner dies, the existence of a surviving spouse or designated beneficiaries, and the ages of these individuals. Roth IRA owners are generally not subject to these distribution requirements during their lifetimes (and are treated as dying before their RBD, see below). (See page 535.)

Owner during lifetime. The owner of a traditional IRA must start receiving distributions by April 1 of the year following the owner's attaining age 70½. This date is referred to as the required beginning date (RBD). Although this first distribution can be delayed, distributions for the second and future years must be made by December 31 (e.g., two distributions would have to be made in a single year if the first distribution was not made until April 1). If the IRA owner dies after reaching age 70½, but before April 1 of the next year, no distribution is required (i.e., death occurred before the RBD).

The amount of the required minimum distribution (RMD) is calculated by dividing the IRA account balance at the end of the previous year by the life expectancy of the IRA owner and another person. This is also referred to as the applicable distribution period, or the RMD factor.

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IRA DISTRIBUTION PLANNING (continued)

For example, assume that an IRA owner is age 75 and has an account balance of $100,000. The RMD uniform lifetime table on page 587 provides an RMD factor of 22.9. The required minimum distribution is $4,367 (100,000 ÷ 22.9 = 4,367). This table is used when the owner is alive, and there is no designated beneficiary or the designated beneficiary is either: (1) a spouse not more than ten years younger than the owner; or (2) a nonspouse beneficiary of any age. Under the incidental benefit rule, this table treats a nonspouse beneficiary as no more than 10 years younger than the IRA owner, thereby assuring that distributions are primarily for the benefit of the IRA owner.

When the owner is alive, and a spouse more than ten years younger than the owner is the sole beneficiary, then the RMD joint and last survivor table can be used (see Appendix F of *Tax Facts on Insurance & Employee Benefits (2015)*). Use of this table is particularly helpful if the spouse is substantially younger than the IRA owner (i.e., a longer joint life expectancy reduces the amount of the annual required minimum distribution). For example, assume that an IRA owner age 75 is married to a spouse age 45, and the account balance is $100,000. The RMD factor from this table is 39.2, and the required minimum distribution is $2,551 (100,000 ÷ 39.2 = 2,551).

Surviving spouse as beneficiary. A surviving spouse who is the sole primary beneficiary of the deceased's IRA can either:

1. Elect to be *designated as the account owner* of the IRA (or use a "spousal rollover" to transfer assets to the spouse's traditional IRA). This allows for using the surviving spouse's age in determining required minimum distributions, and for the naming of new designated beneficiaries (i.e., the so-called "stretch IRA," see page 432). However, if withdrawn by a surviving spouse under age 59½, these funds may be subject to the 10 percent early distribution penalty tax (a spouse who remains a beneficiary is not subject to this tax), or

2. Remain a *beneficiary* of the IRA, with the following results:

    a. Distributions must generally be taken over the surviving spouse's lifetime (using the single life expectancy of the spouse). The first distribution must be made by the end of the year following the owner's death.

    b. If the IRA owner dies *on* or *after* the RBD, the life expectancy of the owner can be used for any year if it is greater than the spouse's life expectancy.

Non-spouse as beneficiary. Distributions to a designated beneficiary (see definition on page 432) are determined by whether the IRA owner dies before the required beginning date (RBD):

(continued on next page)

IRA DISTRIBUTION PLANNING (continued)

1. If the owner dies *before* the RBD, distributions must be made using the beneficiary's life expectancy under the RMD single life table (see Appendix F of *Tax Facts on Insurance & Employee Benefits (2015)*). This life expectancy is determined by using the beneficiary's age in the year following the owner's death, reduced by one for each year after the year of death. For example, assume the owner died in 2010 and the beneficiary was age 50 in 2011. Using the single life table, the factor is 34.2 in 2011, 33.2 in 2012, and 32.2 in 2013 (applying the subtract-one method).

2. If the owner dies *on* or *after* the RBD, distributions are generally based upon the longer of:

   a. The life expectancy of the *beneficiary* under the RMD single life table, or

   b. The life expectancy of the *owner* under the RMD single life table using the owner's age as of his or her birthday in the year of death, reduced by one for each year after the year of death.

No designated beneficiary. Distributions are again determined by whether the IRA owner dies before the required beginning date (RBD):

1. If the owner dies *before* the RBD, distributions must be made under the five-year rule. The entire account must be distributed by the end of the fifth year (sixth year, if 2009 is one of the five years) after the owner's death, but no distribution is required before then.

2. If the owner dies *on* or *after* the RBD, distributions continue to made based upon the life expectancy of the owner under the RMD single life table using the owner's age as of his or her birthday in the year of death, reduced by one for each year after the year of death.

Trust as beneficiary. A trust cannot technically be a designated beneficiary for RMD purposes, but the oldest beneficiary of a trust will be treated as the designated beneficiary if the trust meets certain specific requirements. (This is commonly known as a "see-through" trust, see page 549.) If the trust fails to meet these requirements, then distributions must be made under the five-year rule. Before making a trust the beneficiary of an IRA, the advice of qualified counsel should be sought.

Designated beneficiary. This is the individual (or certain trusts) who is designated to receive the IRA proceeds by the terms of the IRA document. Generally, the designated beneficiary will be determined as of September 30 of the calendar year following the year of the owner's death.

LEGAL EXPENSE BENEFIT

Given our litigious society, it is hardly surprising that the legal expense benefit has grown in popularity as an employee benefit. Intended to provide affordable access to legal services, these benefits are referred to as "legal service plans," "prepaid legal services," and "discount legal plans." Plans providing legal expense benefits are offered in a variety of forms, including legal referral networks, prepayment plans, and indemnity plans.

Prepayment plans are similar in concept to HMOs, and provide for services from specific groups of lawyers employed by or under contract to the plan, specific lists of attorneys, or attorneys of choice. Less common are indemnity plans that provide benefits by reimbursing employees for specific legal services, with reimbursements limited to flat amounts, hourly rates, and maximum annual benefits.

Benefits are provided on either a comprehensive or scheduled basis. Plans providing comprehensive benefits typically provide full legal services, with specific services excluded. More common are plans providing only scheduled services. Typical of all plans is their emphasis on preventative law.

A variety of services are available. Most plans offer telephone consultations, document review, phone calls on the client's behalf, letter writing, and contract review. While many services are available without limit, limits are likely to be placed on some services (e.g., contract review limited to 10 pages; trial preparation and representation limited to 75 hours of attorney time). Excess time is typically charged at reduced rates.

Covered are family law matters such as divorce, adoption, child custody, will services, and estate planning; property rights such as real estate and probate matters; IRS audit representation; and trial defense on civil matters. Criminal defense work is excluded, except for moving vehicle violations and work-related criminal charges. Generally no coverage is provided for plaintiff actions, and virtually all nonunion plans specifically exclude actions against the sponsoring employer.

In evaluating a plan, it is important to determine the availability of attorneys, as well as the specific services offered (e.g., attorneys may not be available for face-to-face consultations, or appointments may be difficult to get).

Most plans are enrolled by payroll deduction, with the individual employee paying for his share of plan costs. These costs are not deductible, but the benefits are tax-free. If the plan is paid for by the employer, the costs are deductible by the employer, provided the employee's total compensation is reasonable. Although the employee must include in income his prorata share of these costs, any benefits received are tax-free.

LEVERAGED BENEFIT

The "best" type of fringe benefit is one that is not taxable to the employee, or at least not currently taxable, yet currently deductible by the employer. Because of this favorable tax treatment, it can be considered a leveraged benefit.

For example, assume that in 2015 an *employee* in a 25 percent marginal tax bracket is in need of $30,000 of additional life insurance protection and is presently receiving only $20,000 of group term coverage. If insurance were individually purchased by the employee for $200, the employer could pay for the benefit by giving the employee a salary of $267 ($200 ÷ .75 = $267). The tax cost of the additional salary of $267 is $67, leaving the employee with $200 to pay the insurance premium. Assuming an *employer* in a 34 percent marginal tax bracket, the after-tax cost to the employer of the salary increase is $176 ($267 × .66 = $176).

To provide a leveraged benefit, the employer could increase the group term coverage by $30,000, which would be tax-free to the employee. Assuming this would cost the employer $200, the after-tax cost of providing the same benefit to the employee is now only $132 ($200 × .66 = $132). The employee gets the needed $30,000 of additional life insurance protection, but the employer has saved $44 by using a leveraged benefit.

Other leveraged benefits include physical examinations, increased mileage allowances, medical expense reimbursement, and employer paid premiums for disability income insurance.

LIFE INSURANCE DEFAULT RISK

Life insurance default risk refers to the possibility that an insurance company might default on its obligations to individual policyholders. The near financial meltdown of the banking industry of the first decade of the 21st century, and its subsequent potential spillover into the insurance industry, is likely to have made the life insurance purchaser far more aware of this risk (see Insurance Company Ratings, page 442).

Life insurance companies are subject to strict regulation by state regulatory agencies. This regulation includes conservative accounting rules, mandatory annual CPA audits, minimum capital/surplus requirements, and investment regulations/limitations (e.g., they are not allowed to invest in complex financial instruments). As a result, in down-market cycles life insurance companies are better positioned to handle greater losses than other companies in the financial sector, and thus better able to maintain adequate reserves to cover their financial obligations to policyholders.

If an insurance company does become financially unstable the insurance department in its home state takes control of the company in a "receivership process." The first step in this process involves an attempt to *rehabilitate* the company by improving its financial status. Sale of the distressed company is often brokered to a stronger company that assumes policyholder obligations. If rehabilitation is not successful, then the company is declared insolvent and the receivership process moves into the *liquidation* stage. Here the receiver attempts to maximize the company's assets in order to pay off as many creditors as possible, including individual policyholders who are given priority over other creditors.

Insolvent insurance companies frequently do not have enough funds to meet their obligations to policyholders. When this occurs state guarantee associations provide policyholders with benefits up to specified limits. The amount varies from state to state, but most states provide at least $100,000 in cash surrender or withdrawal values for life insurance and $300,000 in life insurance death benefits (a quick link to each individual state association website is available by going to www.nolhga.com/policyholderinfo/main.cfm/location/ga). Unfortunately, 100 percent of policyholder benefits are not covered in full, particularly as to high-dollar policies.

It is important to distinguish between separate account products and general account products. Assets backing variable products, such as variable life insurance, are held in separate accounts that are insulated from the general creditors of the company. In contrast, assets backing fixed products, such as whole life and universal life insurance, are held in the company's *general* account, which is subject to the claims of all the creditors of the insurance company. (The general account also backs guaranteed death benefits and other available riders and endorsements.) Although this credit-risk exposure may be low, it nevertheless exists. Now, more than ever, it is important to consider the ratings of the issuing carrier as an essential part of the life insurance purchase process (see leading rating agencies on page 442).

LIFE INSURANCE IN QUALIFIED PLANS

Qualified plans can offer an attractive way of using pretax dollars to purchase life insurance for the benefit of plan participants. In pension plans the plan trustee determines to purchase life insurance as a plan asset; plan participants do not have the power to direct plan investments. In defined contribution plans, such as profit sharing and 401(k) plans, each participant has the ability to elect to purchase life insurance with part of his or her account (e.g., from a self-directed account). Qualification rules do not require that all employees actually purchase life insurance. Discrimination against non-highly compensated employees is prohibited and if life insurance benefits are available to the highly compensated employees they must be available to all employees. Generally, the plan trustee is named owner and beneficiary of the life insurance policy.

Amount of insurance. Pension plans exist primarily to provide retirement benefits and profit sharing plans are primarily plans of deferred compensation. When these plans provide life insurance coverage for plan participants the life insurance must be an "incidental benefit" under the plan. This incidental benefit limitation is satisfied if the cost of providing a current life insurance benefit is less than 25 percent of the cost of providing all the benefits under the plan (both deferred and current). Staying within either of the following will satisfy this incidental benefit limitation:

1. The death benefit is no more than 100 times the expected monthly retirement benefit, or

2. At all times over the life of the plan total premiums paid for the insurance death benefit are less than the following percentages of total funds allocated to that participant:

   50% - for ordinary life insurance or variable life insurance

   25% - for term life insurance or universal life insurance

These limits may be used by any type of plan, although the "100 times" limit has typically been used by defined benefit plans and the "percentage limit" by defined contribution plans (e.g., profit sharing plans). See table, Types Of Qualified Retirement Plans, on page 519.

Profit sharing plans are an exception to these limits. There is no limit on the amount of life insurance that may be purchased with trust funds that have accumulated for two or more years, provided the plan requires that only such funds can be used to purchase life insurance (i.e., the "seasoned money" concept). Individual retirement accounts are prohibited from owning life insurance.

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LIFE INSURANCE IN QUALIFIED PLANS (continued)

Premiums. With a defined benefit plan the additional cost associated with the purchase of life insurance increases the total amount deductible as a plan contribution (i.e., the cost of life insurance is on top of the maximum funding limits). In contrast, with a defined contribution plan premiums are paid from the participant's account without increasing the annual additions limit (in ~~2014~~, the lesser of 100 percent of compensation, or $~~52,000~~).

Insured. Insurance is generally provided on the life of the plan participant for family protection or estate needs. However, in profit sharing plans where life insurance is purchased in self-directed accounts, insurance may be purchased on the lives of third parties (e.g., a spouse for family protection, a business partner to fund a buy/sell agreement, or a survivorship life policy on both the participant and spouse for estate liquidity needs).

Taxation. Each year the plan participant must include in income the economic value of the current life insurance protection (i.e., death benefit less cash values, if any). This includable cost is calculated using the lower of (a) the Table 2001 rates on page 588, or (b) the insurer's published rates for initial issue one-year term for standard risks. Except for owner-employees of unincorporated businesses, the cumulative value of these taxable amounts constitutes the participant's "basis" in the contract. (This can be a substantial benefit for the highly rated individual who reports an economic benefit based upon standard rates.) If the insured dies while the policy is held within the plan, the death benefit in excess of the policy's cash value (the amount "at risk") is received by the beneficiary free of income taxes. The remaining distribution, reduced by the participant's basis in the contract, is taxed as a qualified plan distribution. Death benefits from a qualified plan are generally includable in a decedent's estate for federal estate tax purposes, under the theory that the participant has an "incidents of ownership" in the policy (see page 405). Account values payable at death to a named beneficiary are classified as income in respect of a decedent and are subject to both income and estate taxes (see page 422).

Disposition of policy. If the insured does not die prior to retirement, the life insurance policy must be either surrendered, distributed, or sold. In making transfers from the plan to third parties, it is important to fall within the parameters set forth in Prohibited Transaction Exemption 92-6 (e.g., sold for "fair market value"). To avoid current income taxation, a policy with cash values may be sold to the insured and then passed by gift from the insured to a third party. If estate taxation is a concern, the policy may be sold directly to an irrevocable life insurance trust established by the insured (see chart, page 51). Provided this trust is considered a grantor trust, this sale would not violate the transfer for value rules (see discussions on pages 414 and 573-574).

See also, the fully insured 412(i) plan, pages 276-279.

LIFE INSURANCE PREMIUM LIMITATIONS

TAMRA limitations. Under TAMRA (Technical and Miscellaneous Revenue Act) a life insurance contract issued on or after June 21, 1988, is subject to being classified as a modified endowment contract (MEC) if cumulative premiums paid during the first seven contract years exceed the sum of "net level premiums" (the seven-pay test). Net level premiums are determined by each carrier and reflect the premiums required to pay up the contract during the first seven years using guaranteed mortality costs and interest rates. Distributions from a MEC are subject to "gain first" taxation to the extent there is gain in the contract (i.e., cash values exceed investment in the contract). Such distributions include withdrawals, loans, and use of the policy as collateral for a loan. Generally, the investment in the contract is the sum of premiums paid, less dividends received, plus prior taxable loans (but not prior taxable withdrawals).

Additionally, a 10-percent-penalty tax is imposed on amounts includable in gross income if the distribution is made prior to the contract owner's attaining age 59½, unless the owner is disabled or receives the cash values under a life annuity settlement option. However, the penalty tax is always applicable if the contract owner is a "non-natural person" (e.g., a corporation or trust).

For example, assume that the "net level premium" for a particular contract is $2,500 and the following payment plans are being considered:

Year	Cumulative Net Level Premium	Plan A		Plan B	
		Annual	Cumulative	Annual	Cumulative
1	2,500	2,000	2,000	2,500	2,500
2	5,000	1,000	3,000	2,500	5,000
3	**7,500**	1,500	4,500	3,000	**8,000**
4	10,000	5,500	10,000	2,000	10,000

Plan A is not a MEC, since at no time did the cumulative amount paid exceed the cumulative net level premiums. However, Plan B became a MEC in year 3, since the cumulative amount paid ($8,000) exceeded the allowable cumulative net level premium ($7,500). In summary, a policy owner can "catch up" after falling behind, but he cannot "get ahead" by paying premiums in advance.

Now assume premiums are paid according to Plan B, and at the end of year 4 the cash values are $11,000. A withdrawal of $2,500 would result in a taxable gain of $1,000, since there is gain of $1,000 in the contract (cash values of $11,000 less cumulative premiums of $10,000).

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LIFE INSURANCE PREMIUM LIMITATIONS (continued)

Once a contract becomes a MEC, it forever stays a MEC (except for limited opportunities given insurance companies to correct procedural errors). In addition, even though a contract is "grandfathered" because it was issued prior to June 21, 1988, it can become a MEC if a "material change" occurs with respect to its benefits or terms. Since it is very broadly defined, virtually any alteration in benefits is likely to be treated as a material change, except for death benefit increases of up to $150,000 (or cost of living increases tied to a broad-based index). Potential material changes can occur when: (1) exchanging an old contract for a new contract; (2) converting term insurance to permanent cash value insurance; (3) adding a new insured to the contract; and (4) increasing the death benefit voluntarily. Contracts issued after June 21, 1988, are also subject to the material change rules.

While it is important to be aware of the potential adverse tax implications of TAMRA, there will be no adverse effect if: (1) the contract was issued prior to June 21, 1988; (2) the death proceeds are the only payments received under the contract; (3) the premium payments do not exceed the seven-pay limits; or (4) the only payment received is pursuant to a complete surrender of the contract after age 59½.

DEFRA limitations. In contrast to TAMRA, it is *absolutely essential* to comply with the guideline premium and corridor test or meet the cash value accumulation test of DEFRA (Deficit Reduction Act). A failure to abide by these limitations will produce disastrous tax results since the contract will immediately lose its status as life insurance, all cash value increases will be subject to current income taxation, and the death benefit will be taxed as ordinary income (to the extent it exceeds cumulative net premiums paid).

For example, assume Plan A is being tested for DEFRA compliance:

	TAMRA	DEFRA		Plan A	
Year	Cumulative Net Level	Guideline Single	Cumulative Annual	Annual	Cumulative
1	2,500	9,000	1,000	2,000	2,000
2	5,000		2,000	1,000	3,000
3	7,500		3,000	1,500	4,500
4	10,000		4,000	5,500	10,000

In year 4, Plan A violates both DEFRA guideline premium tests. Under this test the cumulative annual premiums cannot exceed either the greater of: (1) the guideline single premium ($9,000); or (2) the guideline cumulative annual premiums ($1,000 per year). Although the cumulative annual premiums were exceeded beginning year 1, Plan A cumulative premiums fell within the guideline single premium ($9,000) until year 4.

LIFE INSURANCE RATINGS AGENCIES

The life insurance industry has been remarkably solid over the years. Insurance companies are heavily regulated by state insurance commissioners and are required to hold considerable reserves to protect their abilities to pay claims. In addition, many larger insurance companies are publicly traded so, in addition to regulation by state insurance commissioners, these companies are governed by federal agencies as a publicly traded corporation.

Historically, in the rare instances when life insurance carriers have experienced financial difficulties, other carriers have typically stepped in and acquired the struggling company or their in-force block of policies. As a result of heavy state and (sometimes) federal regulations, combined with insurance industry leaders protecting the industry by acquiring distressed companies and policies, the insurance industry has done a remarkably good job of paying insurance claims.

Despite the industry's strong record of solvency and honoring claims, it is important to note that state guaranty associations provide only limited protection to their residents. The maximum death benefits protected by these state guarantee funds often fall short of the coverage that a family should buy. In fact, death benefits are protected only up to $300,000 in many states, so consumers with larger policies could be left out in the cold. Moreover, many states provide only $100,000 coverage for cash surrender or withdrawal value of permanent policies and annuities.

As previously noted, before state guaranty fund payouts kick in, regulators will try to rehabilitate, sell, or liquidate the company. If that happens, you could see an acquiring company adjust your coverage by increasing the premium or otherwise making the terms less favorable. Moreover, if you die while your carrier is in state receivership or liquidation, the payment of benefits, up to state limits, could even be delayed.

Despite the insurance industry's strong track record of paying claims, there are real risks associated with a long-term obligation like life insurance. For this reason, it remains important to consider the size, ratings, and stability of the company issuing your policy. Not surprisingly, you sometimes see lower premium costs and aggressive policy features from carriers with lower ratings. In essence, the insured (and his or her beneficiary) is paying less in exchange for accepting a degree of solvency risk. When purchasing life insurance protection, it isn't enough to simply "spreadsheet" premium costs. Consideration of policy features and flexibility is important – as is consideration of the stability of the issuing company. Reviewing carrier financial statements can be an important means of determining carrier financial strength, but obtaining third party rating agency summaries is probably the easiest and most widely used method of evaluating claims paying ability.

The following page introduces you to A.M. Best, Standard & Poor's, Moody's, and Fitch. These ratings agencies are generally regarded as the leaders in evaluating claims paying ability. Although the various agencies generally look at similar information and seek to make similar assessments – it is generally wise to consider multiple ratings when making your evaluation of carrier strength. Page 443 shows you select ratings for a number of the larger life insurance

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LIFE INSURANCE RATINGS AGENCIES (continued)

companies. Ratings are not the only important consideration when selecting a life insurance company, but they can help you reach an informed decision regarding policy selection or retention. We also provide a chart below with the 30 largest life insurers in the United States along with each companies' ratings by the various agencies.

INSURANCE COMPANY RATINGS

Rating Categories[1]	A.M. Best[2]	S&P[3]	Moody's[4]	Fitch[5]
Superior	A++	AAA	Aaa	AAA
	A+			
Excellent	A	AA[6]	Aa[7]	AA[6]
	A-			A[6]
Good	B++	A[6]	A[7]	
	B+			
Fair	B	BBB[6]	Baa[7]	BBB[6]
(Adequate)	B-			
Marginal	C++	BB[6]	Ba[7]	BB[6]
	C+			
Weak	C	B[6]	B[7]	B[6]
	C-			
Poor	D	CCC	Caa[7]	CCC[6]
(Below Standards)		CC	Ca	CC, C
			C	
Failed	E[8], F[9]	D[10]		

[1] The comparative distribution of rating categories is approximate. Therefore, the ratings definitions of each agency should be consulted. The basic mission of all of these independent agencies is to assess an insurer's financial strength in terms of its ability to meet policyholder and other contractual obligations, and to communicate those findings to the financial and investment communities. Due diligence requires not just a determination of the assigned rating, but an understanding of how each rating agency determines its published ratings.

[2] A.M. Best's Financial Strength Rating provides an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations (has rated insurers since 1899).

[3] Standard & Poor's (S&P) publishes Insurer Financial Strength Ratings (has rated debt issues for over 50 years and insurance companies since 1971).

[4] Moody's Insurance Financial Strength Ratings are opinions of the ability of insurance companies to repay punctually senior policyholder claims and obligations (has rated bond issues since 1904 and insurers since the 1970s).

[5] Fitch, Inc. publishes National Insurer Financial Strength Ratings. Ratings below AAA and above CC may be appended with a "+"or "–" to indicate relative position within the rating category.

[6] Includes three levels of ratings (i.e., AA-, AA, AA+; A-, A, A+; BBB-, BBB, BBB+; BB-, BB, BB+; B-, B, B+; CCC-, CCC, CCC+; D-, D, D+; E-, E, E+).

[7] Includes three levels of ratings (i.e., Aa1, Aa2, Aa3; A1, A2, A3; Baa1, Baa2, Baa3; Ba1, Ba2, Ba3; B1, B2, B3; Caa1, Caa2, Caa3).

[8] Under regulatory supervision.

[9] In liquidation.

[10] Payment default on financial commitments.

LIFE INSURANCE RATINGS AGENCIES (continued)

TOP LIFE INSURER RATINGS PROFILE[1]

	A.M. Best	S&P	Moody's	Fitch
Northwestern Mutual	A++	AA+	Aaa	AAA
New York Life	A++	AA+	Aaa	AAA
Lincoln National Life Insurance Company	A+	AA-	A1	A+
Transamerica	A+	AA-	A1	AA-
State Farm Life	A++	AA	Aa1	
Pacific Life	A+	A+	A1	A+
Prudential Financial	A+	AA-	A1	A+
MassMutual Financial Group	A++	AA+	Aa2	AA+
MetLife Companies	A+	AA-	Aa3	AA-
John Hancock Life Insurance Company	A+	AA-	A1	AA-
Guardian Life Ins Co of America	A++	AA+	Aa2	AA+
American General Life Companies	A	A+	A2	A+
Zurich North America	A	A	A3	
Mutual of Omaha Companies	A+	A+	A1	
Nationwide Life	A+	A+	A1	
Primerica Life Insurance	A+	AA-	A2	
Minnesota Life	A+	A+	Aa3	AA-
Banner Life Insurance Company	A+	AA-		
AXA Equitable	A+	A+	Aa3	AA-
National Life Group	A	A	A2	
NACOLAH Life (Illinois)	A+	A+		
Bankers Life and Casualty (Illinois)	B++	BBB+	Baa2	BBB
Allianz Life of NA	A	AA	A2	
Protective Life	A+	AA-	A2	A
Allstate Life	A+	A+	A1	A-
RiverSource Life Insurance Company	A+	AA-	Aa3	
Penn Mutual	A+	A+	Aa3	
Principal Life Group	A+	A+	A1	AA-
Ohio National Life Companies	A+	AA-	A1	
Gerber Life Insurance Company	A	BBB		

[1] *Source*: LIMRA Research, 2Q 2014.

LIFE INSURANCE IN RETIREMENT PLANNING ("LIRP")

For many people, planning for retirement has become one of their biggest financial priorities and one of their greatest financial challenges. Many people fear that Social Security and company-sponsored pension plans will not provide sufficient income for their retirement goals. As a result, they recognize the need to save as much money as possible to supplement their retirement.

Ordinarily, qualified plans such as a 401(k) (see pages 268-271) or a 403(b) (see pages 272-275) are an excellent way to save for retirement, but these plans are only available if your employer offers one. And, if offered, these plans have contribution limitations which may not meet your full savings needs. IRAs (see page 424) and Roth IRAs (see page 535) both offer additional qualified savings opportunities, but they have their own limits (dollar amounts and income levels) to participate or deduct. Ultimately you may still need to put away more money.

Especially with today's ordinary income and capital gains tax rates at higher marginal rates than in recent memory, people are often looking for ways to help them supplement their retirement savings after they have fully funded their available qualified plans and IRAs. For these people, life insurance may be a solution. During your working years, the life insurance policy death benefit can protect your family and replace income that would otherwise be lost should something happen to you. At retirement, you can usually access the policy cash value via tax-favored loans and withdrawals.

Life Insurance in Retirement Planning, sometimes referred to as Life Insurance Retirement Plans, 401k Alternative or Supplement Income, is a simple means of self-funding your retirement needs. It is not a qualified plan and is not backed by the federal government. A LIRP arrangement simply requires the purchase of a permanent life insurance policy on your life on which you will pay the premiums with after-tax dollars.

The life insurance policy will provide a death benefit that will ordinarily be received by the beneficiary on an income tax-free basis. This can help protect a family during a client's working years. Because a permanent life insurance policy also has the potential to develop a cash value, which will grow on a tax-deferred basis, you may access any potential policy cash to supplement your retirement income via tax-favored loans and withdrawals. Life insurance offers many benefits, including the potential to increase the amount left to heirs. Because life insurance cash surrender values grow tax-deferred, the policy cash surrender values are not reduced by ordinary income or capital gains taxation.

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LIFE INSURANCE IN RETIREMENT PLANNING ("LIRP") (continued)

For Example.

Jane Smith, Female, Preferred Non Smoker, Age 40, 28% Tax Bracket,

Year	Approximate Annual Premium	Cumulative Amount Received from Policy	Approximate Cash Surrender Value	Approximate Death Benefit Net of Loans/ Withdrawals
1	$4,500	$0	$637	$153,650
10	$4,500	$0	$50,400	$200,500
20	$4,500	$0	$155,600	$305,600
26	$0	$20,000	$233,750	$350,650
30	$0	$100,000	$208,100	$270,650
40	$0	$300,000	$112,400	$128,300

The figures used in this case study are hypothetical, for discussion purposes only, are not guaranteed and may not be used to project or predict results. Actual results may be more or less favorable. Specific product and policy elements would be found in a policy illustration provided by an insurer. With any decision regarding the purchase of life insurance, a client would need to determine which type of life insurance product is most suitable for their specific needs.

1. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. Please consult your professional tax advisor.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

INSURANCE PRODUCTS:		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	

LIFE INSURANCE AND STATE LAWS

ALABAMA

Death Benefit: Exempt from debts of owner and/or insured if payable to someone other than owner or insured whether or not the right to change the beneficiary has been reserved. [Ala. Code § 6-10-8]

Endowment and Surrender Proceeds: Cash surrender value is exempt from claim of creditors if spouse and/or children named as beneficiaries. Exempt proceeds includes death benefits, cash surrender and loan values, premiums waived and dividends. [Ala. Code § 27-14-29(c)]

Bankruptcy

Federal: Federal exemptions not available. [Ala. Code §6-10-11]

State: State exemptions same as non-bankruptcy context above.

ALASKA

Death Benefit: Proceeds payable to a spouse or dependent of the insured are considered "earnings" and are exempt to the extent that do not exceed $456 per week. (Amount is indexed annually for inflation) [Alaska Stat § 09.38.030(a) and (c)(4)]

Endowment and Surrender Proceeds: Unmatured annuity and life insurance contracts are exempt from creditors' claims up to $500,000. [Alaska Stat. §09.38.025]

Bankruptcy

Federal: Federal exemptions not allowed. [§09.38.055]

State: State exemptions same as non-bankruptcy context above.

ARIZONA

Death Benefit: Exempt from the debts of the owner if payable to a person other than the owner or owner's legal representatives. [Ariz. Rev. Stat. §20-1131] Proceeds made payable to a surviving spouse or child of the insured are exempt from creditors up to $20,000. [Ariz. Stat. §33-1126.A.6]

Endowment and Surrender Proceeds: Exempt if debtor has for a continuous unexpired period of two years, has named the insured's surviving spouse, child, parent, brother, sister or other dependent as beneficiary. [Ariz. Rev. Stat. §20-1131 and §33-1126.A.6]

Bankruptcy

Federal: Federal exemptions not available. [Ariz. Rev. Stat. §33-1133]

State: State exemptions same as non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

ARKANSAS

Death Benefit: Proceeds of life insurance are exempt from claims of creditors of the insured or the beneficiary whether or not the right to change beneficiary has been reserved. [A.C.A. §23-79-131 and A.C.A. §16-66-209]

Endowment and Surrender Proceeds: Exempt but the courts have imposed a $500 exemption ceiling on life insurance benefits and policies' cash surrender value. *Federal Savings and Loan Ins. Co. v. Holt*, 894 F2d 1005 (8th Circuit 1990)

Bankruptcy

Federal: Federal exemptions are available. [A.C.A. §16-66-217]

State: State exemptions same as non-bankruptcy context which means subject to $500 limited exemption.

CALIFORNIA

Death Benefit: Exemption available to the extent necessary for the support of judgment debtor and spouse and dependents of debtor. [Cal. Code of Civ. Proc. §704.100(c)]

Endowment and Surrender Proceeds: Loan value of unmatured policies are exempt from debts of owner to the extent of $11,475. ($22,950 if married) (adjusted every three years) [Cal. Code of Civ. Proc. §704.100(b) and §703.150]

Bankruptcy

Federal: Federal exemptions are not available. [Cal. Code of Civ. Proc. §703.130]

State: One of two options are available (1) Same state exemptions as in non-bankruptcy (2) Unmatured life insurance policy owned by debtor may be exempted up to $12,860 (adjusted every three years) of debtor's aggregate interest in any accrued dividend or interest under, or loan value of the policy if the debtor is the insured or a dependent of the insured. [Cal. Code of Civ. Proc. §703.140(b)(8)]

COLORADO

Death Benefit: Exempt from debts of insured when paid to beneficiary other than insured's estate. [C.R.S. §13-54-102]

Endowment and Surrender Proceeds: Exempt up to $100,000 from the debts of the insured except for increases contributed up to 48 months before writ of attachment or execution is issued. [Colo. Rev. Stats. §13-54-102(1)(I)(A)]

Bankruptcy

Federal: Federal exemptions not available. [C.R.S. §13-54-107]

State: State exemptions same as in non-bankruptcy context. [C.R.S. §13-54-107]

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LIFE INSURANCE AND STATE LAWS (continued)

CONNECTICUT

Death Benefit: Exempts from debts of insured when paid to a beneficiary other than the insured's estate. [C.G.S.A. §38a-453]]

Endowment and Surrender Proceeds: Loan values of unmatured policies up to $4,000 are exempt if the insured is the person claiming the exemption or a dependent of the insured. [C.G.S.A. §52-352b]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions same as in non-bankruptcy. [C.G.S.A. 38a-453]

DELAWARE

Death Benefit: Exempt from claims of insured if payable to someone other than insured and exempt also from debts of the beneficiary. [Del. Code Ann. Title 18 §2725]

Endowment and Surrender Proceeds: No statutory provision.

Bankruptcy

Federal: Federal exemptions not available. [Del. Code Ann. Title 10 §4914]

State: State exemptions same as in non-bankruptcy context above.

DISTRICT OF COLUMBIA

Death Benefit: Exempt from debts of insured if payable to someone other than insured. [DC ST §31-4716] Death benefits are exempt from debts of beneficiary if debtor was a dependent of the insured and is head of household or family. [DC ST §15-501(11)(C) In other situations, death benefit is exempt from debts of

beneficiary up to $400 if beneficiary is providing support for family or $120 if not providing support. [DC ST §15-503

Endowment and Surrender Proceeds: Unmatured policy is exempt from debts of owner other than a credit insurance contract. [DC ST 15-501(5)]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

FLORIDA

Death Benefit: Proceeds of life insurance paid to any named beneficiary (other than insured's estate) are exempt from the claims of the insured's creditors. [F.S.A. §222.13]

Endowment and Surrender Proceeds: Exempt from debts of the insured. [F.S.A. 222.14]

Bankruptcy

Federal: Federal exemptions not available except those listed at 11 U.S.C. §522(d)(10), F.S.A. §222-20 and §222.201.

State: State exemptions same as in non-bankruptcy context above.

GEORGIA

Death Benefit: Exempt from debts of insured if payable to someone other than insured or his estate. [Ga. Code Ann. §33-25-11]

Endowment and Surrender Proceeds: Exempt from the debts of the owner-insured. [Ga. Code Ann. §33-25-11]

Bankruptcy

Federal: Federal exemptions are not available. [Ga. Code Ann. §44-13-100(b)]

State: State exemptions same as non-bankruptcy context above except only $2,000 of cash surrender value is exempt. [Ga Code Ann. §44-13-100(a)(8). Debtor can also exempt proceeds of an insurance policy received on an insured of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor and any dependents of debtor. [Ga. Code Ann. §44-13-100(a)(11)(C)]

HAWAII

Death Benefit: Exempt from the debts the owner and/or insured if payable to the insured's spouse, child, parent or other dependent, and from debts of beneficiaries under a settlement plan. [H.R.S. §431:10-232]

Endowment and Surrender Proceeds: Exempt when policy is payable to insured's spouse, child, parent or other dependent. [H.R.S. §431:10-232]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions same as in non-bankruptcy context above. [H.R.S. 431:10-232]

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LIFE INSURANCE AND STATE LAWS (continued)

IDAHO

Death Benefit: Exempt from debts of owner and/or insured as long as payable to someone other than owner and/or insured. Also exempt from debts of the beneficiary. [Idaho Code §41-1833]

Endowment and Surrender Proceeds: Unmatured policies are exempt. Dividends, interest and loan values are exempt up to $5,000. [Idaho Code § 11-605(9) and §11-605(10)]

Bankruptcy

Federal: Federal exemptions are not available. [Idaho Code §11-609]

State: State exemptions same as in non-bankruptcy context above. [Idaho Code §11-609]

ILLINOIS

Death Benefit: Exempt from debts of insured if payable to insured's spouse, child, parent, or other dependent. Death benefit exempt from debts of beneficiary to the extent reasonably necessary for the support of beneficiary and/or dependents if beneficiary was a dependent of the insured. [735 IL CS §5/12-1001(h) and 215 IL CS §5/238(a)]

Endowment and Surrender Proceeds: Exempt when policy is payable to insured's spouse, child, parent or other dependent. [735 IL CS §5/12-1001(f)]

Bankruptcy

Federal: Federal exemptions are not available. [735 IL CS §5/12-1201]

State: State exemptions same as in non-bankruptcy context above.

INDIANA

Death Benefit: Exempt from debts of insured and spouse if payable to the spouse, child or any relative dependent of the insured. [I.C. §27-1-12-14] A policy naming as beneficiary, or assigned to, a spouse, child or dependent relative of the insured is exempt from the claims of creditors. This includes death proceeds, cash surrender and loan values, premiums waived and dividends. [I.C. §27-1-12-14]

Endowment and Surrender Proceeds: Exempt from creditors of the insured and the insured's spouse when policy is payable to insured's spouse, child, parent or other dependent. [I.C. §27-1-12-14]

Bankruptcy

Federal: Federal exemptions are not available. [I.C. §34-55-10-1]

State: State exemptions same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

IOWA

Death Benefit: Exempt from debts of the insured if payable to spouse, children, or other dependent of the insured. [Iowa Code Ann. §627.6(6) Death benefit also exempt from up to $15,000 from the debts of a beneficiary if beneficiary is a surviving spouse, child or dependent of the insured. [Iowa Code Ann. §627.6(6)]

Endowment and Surrender Proceeds: Exempt from execution any interest in dividend, interest, loan or cash surrender value if the beneficiary is a dependent but only to the amount of $10,000. [Iowa Code Ann. §627.6(6)]

Bankruptcy

Federal: Federal exemptions are not available. [Iowa Code Ann. §627.10]

State: State exemptions same as in non-bankruptcy context above.

KANSAS

Death Benefit: Exempt from debts of owner, insured and beneficiary to any person having an insurable interest in the insured. [Kan. Stat. Ann. §40-414]

Endowment and Surrender Proceeds: Exempt from creditors of the owner if policy payable to person has insurable interest in the insured and the policy was issued within the past year. [Kan. Stat. Ann. §40-414]

Bankruptcy

Federal: Only the exemptions provided by 11 U.S.C. 522(d)(10) are available. [Kan. Stat. Ann. §60-2312]

State: State exemptions same as in non-bankruptcy context above.

KENTUCKY

Death Benefit: Exempt from debts of the owner and/or insured if payable to someone other than the owner and/or insured and also exempt from debts of the beneficiary. [K.R.S. 304.14-300]

Endowment and Surrender Proceeds: Exempt from the debts of the owner. [K.R.S. §427.170]

Bankruptcy

Federal: Federal exemptions are available. [K.R.S. §427.170]

State: State exemptions same as in non-bankruptcy context above.

LOUISIANA

Death Benefit: Exempt from the debts of the insured, the owner or their estates and also from the debts of the beneficiary. [LSA-R.S. §22-912(A)(1)]

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LIFE INSURANCE AND STATE LAWS (continued)

Endowment and Surrender Proceeds: Exempts but limited to $35,000 if the policy was issued within nine months of the policy being issued. [LSA-R.S. §22-912(A)(1)]

Bankruptcy

Federal: Federal exemptions are not available. [LSA-R.S. §13.3881(B)(1)]

State: State exemptions same as in non-bankruptcy context above.[LSA-R.S. 13.3881(B)(1)]

MAINE

Death Benefit: Exempt from debts of owner and/or insured if payable to someone other than owner and/or insured and also exempt from debts of the beneficiary. [24-A M.R.S.A. §2428]

Endowment and Surrender Proceeds: Unmatured life insurance owned by the debtor are exempt. Dividends, interest and loan values exempt from debts of debtor up to $4,000, provided insured is the debtor or debtor's dependent. [14 M.S.R.A. §4422(10)

Bankruptcy

Federal: Only federal exemptions provided by 11 U.S.C. 522(b)(3)(A) and (B) are available. [14 M.S.R.A. §4426]

State: State exemptions same as in non-bankruptcy context above. [14 M.S.R.A. §4426]

MARYLAND

Death Benefit: Exempt from debts of insured if payable to spouse, child or dependent of the insured. [MD Code Ann. Insurance §16-11] Death benefits exempt from debts of beneficiary. [MD Code Ann. Court and Judicial Proc. §11-504(b)(2)]

Endowment and Surrender Proceeds: Exempt from debts of owner if beneficiary is spouse, child or dependent relative of the insured. [MD Code Ann. Insurance §16-111)]

Bankruptcy

Federal: Federal exemptions are not available [MD Code Ann. Court and Judicial Proc. §11-504(g)]

State: State exemptions same as in non-bankruptcy context above.

MASSACHUSETTS

Death Benefit: Exempt from debts of owner if policy payable to a beneficiary other than the owner. [M.G.L.A. ch. 175 §125] Death benefits exempt from debts of beneficiary. [M.G.L.A. ch. 175 §§119A and 126]

Endowment and Surrender Proceeds: Exempt from debts of owner if beneficiary has been unchanged since policy's issuance. [M.G.L. ch. 175 §125]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

MICHIGAN

Death Benefit: Exempt from the debts of owner and/or insured if payable to someone other than the owner and/or insured. [M.C.L.A. §500.2207]

Cash Value: Exempt from debts of the owner. [M.C.L.A. §500.2207]

Bankruptcy

Federal: Federal exemptions are available [M.C.L.A. 600.6023]

State: State exemptions same as in non-bankruptcy context above.

MINNESOTA

Death Benefit: Exempt from the debts of the owner if payable to someone other than the owner [Minn. Stats. Ann. §61A.12] and up to $46,000 of death benefit exempt from the debts of beneficiary if a spouse or dependent child (increased by $11,500 for each additional dependent child) [Minn. Stats. Ann. §550.37(10)]

Cash Value: Up to $9,600 in any dividends, interest or loan value exempt from debts if owner is insured or dependent of the insured. [Minn. Stats. Ann. §550.37(23)

Bankruptcy

Federal: Federal exemptions are allowed. [Minn. Stats. Ann. §550.371]

State: State exemptions same as in non-bankruptcy context above.

MISSISSIPPI

Death Benefit: Exempt from debts of insured if payable to someone other than insured. [Miss. Code Ann. §85-3-11]

Cash Value: Exempt from debts of insured if payable to someone other than the insured; provided, that a maximum of $50,000 of cash value is exempt if purchased within 12 months of issuance. [Miss. Code Ann. §85-3-11]

Bankruptcy

Federal: Federal exemptions are not available. ~~(~~Miss. Code Ann. §85-3-2~~)~~

State: State exemptions same as in non-bankruptcy context above. [Miss. Code Ann. §85-3-11]

MISSOURI

Death Benefit: Exempt from the debts of the owner and/or insured and also exempt from the debts of the beneficiary. [Mo. Rev. Stat. §§377.330 and 513.430.1]

Cash Value: Wholly exempt from debts of owner. [Mo. Rev. Stat. §§377.330 and 513.430.1(7)]

Bankruptcy

Federal: Federal exemptions not available. [Mo. Rev. Stat. §513.427]

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LIFE INSURANCE AND STATE LAWS (continued)

State: State exemptions same as in non-bankruptcy context above except that the cash value of an insurance policy is exempt only to a maximum of $150,000. No exemption for cash value of an insurance policy if purchased within one year prior to commencement of bankruptcy. [Mo. Rev. Stat. §513.430.1(8)]

MONTANA

Death Benefit: Exemption from the debts of owner and/or the insured if payable to someone other than the owner and/or insured. [MT ST §33-15-511]

Endowment and Surrender Proceeds: Wholly exempt from debts of owner. [MT ST §25-13-608(k)]

Bankruptcy

Federal: Federal exemptions are not available. [MT ST §32-2-106]

State: State exemptions are available as provided in MT ST §32-2-106(1).

NEBRASKA

Death Benefit: Exemption from debts of insured if payable to someone other insured or insured's estate. Death benefit also exempt from debts of beneficiary is related to the insured by blood or marriage. [Neb. Rev St. §444-371]

Endowment and Surrender Proceeds: Up to $100,000 are exempt from debts of owner provided that the cash value associated with contributions or premiums are not exempt if made within three years of bankruptcy. [Neb. Rev. St. §44-371(1)(b)]

Bankruptcy

Federal: Federal exemptions are not available. [Neb. Rev. St. §25-15.105]

State: State exemptions are available same as in non-bankruptcy context above. [Neb. Rev. St. §25-15.1050

NEVADA

Death Benefit: Exempt from the debts of owner and/or insured if payable to someone other than owner. Also exempt from the debts of the beneficiary. [NRS §687B.260]

Endowment and Surrender Proceeds: Exempt from debts of the owner. [NRS §21.090.1(k)]

Bankruptcy

Federal: Federal exemptions are not available. [NRS 21.090.3]

State: State exemptions are available same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

NEW HAMPSHIRE

Death Benefit: Exempt from debts of the owner [N.H. Rev. Stat. §408] and exempt from the debt of the beneficiary. [N.H. Rev. Stat. §408.1]

Endowment and Surrender Proceeds: No exemption is available. [N.H. Rev. Stat. §408.2]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions are available same as in non-bankruptcy context above.

NEW JERSEY

Death Benefit: Exempt from debts of owner and/or insured if payable to someone other than owner and/or insured and from debts of beneficiary. [N.J.S.A. 17B:24-6]

Endowment and Surrender Proceeds: Exemption available if beneficiary is someone other than the owner and/or insured. [N.J.S.A. 17B:24-6]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions are available same as in non-bankruptcy context above.

NEW MEXICO

Death Benefit: Exempt from debts of the insured except by special contract in writing. [NM ST §42-10-5]

Endowment and Surrender Proceeds: Exempt from debt of the owner. [NM ST §42-10-3]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions are available same as in non-bankruptcy context above.

NEW YORK

Death Benefit: Exempt from debts of insured and/or owner if payable to someone other than insured and/or owner. Death benefit is exempt from debts of the owner who is a spouse of the insured. [NY Insurance Law §3212]

Endowment and Surrender Proceeds: Exempt from debts of owner and/or insured if payable to insured's spouse and/or children. [NY Insurance Law §3212(b)

Bankruptcy

Federal: Federal exemptions are not available. [NY Debtor and Creditor Law §284]

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LIFE INSURANCE AND STATE LAWS (continued)

State: State exemptions are available same as in non-bankruptcy context above. [NY Debtor and Creditor Law §282]

NORTH CAROLINA

Death Benefit: Exempt from debts of insured and/or owner is payable to someone other than the owner and/or insured. [N.C. Gen. Stat. §1C-1601(a)(6)]

Endowment and Surrender Proceeds: Whole exempt from debts of owner and/or insured is payable to insured's spouse and/or children. [N.C. Gen. Stat. §58-58-95]

Bankruptcy

Federal: Federal exemptions are not available. [N.C. Gen. Stat. §1C-1601(f)]

State: State exemptions are available same as in non-bankruptcy context above. [N.C. Gen. Stat. §1C-160(f)]

NORTH DAKOTA

Death Benefit: Exempt from debts of the deceased even when payable to deceased as well as to wife, children or dependent relative. (ND C.C. §§26.1-33-40]

Endowment and Surrender Proceeds: Exempt absolutely from debts of owner and/or insured up to a maximum of $8,000. [ND C.C. §§26.1-33-36]

Bankruptcy

Federal: Federal exemptions are not available. [ND C.C. §28-22-17]

State: State exemptions are available same as in non-bankruptcy context above.

OHIO

Death Benefit: Exempt from debts of insured if payable to insured's spouse, children, dependent relative, charity or creditor. Also exempt if payable to trust for the benefit of any of the aforementioned. [Ohio Revised Code §3911.10,§2329.66(A)(6)(b)]

Endowment and Surrender Proceeds: Same as above.

Bankruptcy

Federal: Federal exemptions are not available. [Ohio Revised Code §2329.662]

State: State exemptions same as in non-bankruptcy context.

OKLAHOMA

Death Benefit: Exempt from the debts of both the insured and the beneficiary. [36 Okla. Stats. Ann.§3611]

Endowment and Surrender Proceeds: Exempt from debts of the insured. [36 Okla. Stats. Ann. §3631.1]

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LIFE INSURANCE AND STATE LAWS (continued)

Bankruptcy

Federal: Federal exemptions are not allowed. [31 Okla. Stats. Ann. §1]

State: State exemptions available same as in non-bankruptcy context above.

OREGON

Death Benefit: Exempt from debts of owner if payable to someone other than owner. [ORS §743.046(1)]

Endowment and Surrender Proceeds: Cash surrender value of a life insurance policy payable to a beneficiary other than the estate of the insured is exempt from claims of creditors. [ORS §743.046(3)]

Bankruptcy

Federal: Federal exemptions are not allowed. [ORS §18.300]

State: State exemptions available same as in non-bankruptcy context above.

PENNSYLVANIA

Death Benefit: Exempt from debts of the insured if payable to spouse, child or dependent relative of insured. [42 Pa. Cons. Stat. §8124(c)]

Endowment and Surrender Proceeds: Cash value is exempt from debts of owner when spouse, child or other relative dependent of the insured is beneficiary. [42 Pa. Cons. Stat. §8124(c)(6)]. When insured is beneficiary, exempt up to the amount of $100 per month. [42 Pa. Cons. Stat. §8124(c)(3)]

Federal: Federal exemptions are available. [42 Pa Cons. Stat. §812(a)]

State: State exemptions are available same as in non-bankruptcy context above.

RHODE ISLAND

Death Benefit: Exempt from debts of owner and/or insured if payable to someone other than insured. [R.I. ST §27-4-11]

Endowment and Surrender Proceeds: Exempts “proceeds and avails”” when beneficiary is other than the owner/insured. An unpublished Rhode Island Superior Court decision held that cash surrender proceeds were included in “proceeds and avails” under R.I. ST §27-4-11.

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions available same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

SOUTH CAROLINA

Death Benefit: Exempt from debts of insured if payable to a beneficiary where proceeds are for benefit of spouse, children or dependents. {S.C. Code §38-63-40(A)] If bankruptcy filed within two years, a maximum of $4,000 is exempt from debts of the owner. [S.C. Code §§38-63-40(A), 15-41-30]

Endowment and Surrender Proceeds: Exempt from debts of insured if payable to insured's spouse, children or dependents. [S.C. Code §38-63-40(A)] Otherwise, up to $4,000 exempt from debts of the owner if debtor is the insured or dependent. [S.C. Code §§15-41-30, 38-65-90]

Bankruptcy

Federal: Federal exemptions are not available. [S.C. Code §15-41-35]

State: State exemptions same as in non-bankruptcy context above.

SOUTH DAKOTA

Death Benefit: Up to $20,000 exempt from debts of insured and beneficiary if payable to insured's spouse and/or children. [SDCL §58-12-4] Up to $10,000 exempt from debts of insured and beneficiary-spouse and/or children if payable to the insured's estate. [SDCL § 43-45-6]

Endowment and Surrender Proceeds: Up to $20,000 exempt from debts of insured and/or owner. [SDCL §58-12-4]

Bankruptcy

Federal: Federal exemptions not available. [SDCL §43-31-30]

State: State exemptions same as in non-bankruptcy context. [SDCL §43-31-30]

TENNESSEE

Death Benefits: Exempt from debts if life insurance is payable to the surviving spouse, children or dependent unless it is payable to the decedent's estate and the will directs otherwise. [Tenn. Code Ann. §§ 56-7-201, 56-7-202 and 56-7-203]

Endowment and Surrender Proceeds: Cash surrender value is exempt if payable to insured's spouse, children or dependent. [Tenn. Code Ann. §56-7-203, *In re Olien*, 256 Bankr. 280 (E.D. Tenn. 2000, *In re Billington*, 376 Bankr. 239 (M.D. Tenn. 2007)]

Bankruptcy

Federal: Federal exemptions are not available. [Tenn. Code Ann. §26-2-112]

State: State exemptions same as in non-bankruptcy context. [Tenn. Code Ann. §26-2-112]

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LIFE INSURANCE AND STATE LAWS (continued)

TEXAS

Death Benefits: Exempt from both debts of insured and the debts of the beneficiary. [Texas Ins. Code §1108:051, 1108:052 and 1108:53]

Endowment and Surrender Proceeds: Exempt from debts of insured. [Texas Ins. Code §1108:51]

Bankruptcy

Federal: Federal exemptions are available.

State: Insurance benefits are exempt for both insured and beneficiary in bankruptcy proceedings. [Texas Ins. Code §1108:051(b)(2)(C)]

UTAH

Death Benefits: Exempt from both the debts of the insured and the beneficiary if payable to the insured's spouse and/or children and provided the contract for insurance was in existence for at least one year. [Utah Code Ann. §78B-5-505(xi),(xii)]

Endowment and Surrender Proceeds: Exempt except that any payments made on the contract within one year preceding a creditor's levy or execution are not exempt. [Utah Code Ann. 78B-5-505(1)(a)(xii)]

Bankruptcy

Federal: Federal exemptions are not allowed unless the individual is a nonresident of the state and has been for the 180 days immediately preceding the filing for bankruptcy. [Utah Code Ann. §78B-5-513]

State: State exemptions available same as in non-bankruptcy context above.

VERMONT

Death Benefits: Exempt from debts of insured and/or owner if payable to someone other than insured and/or owner. Also exempt from debts of the beneficiary to the extent reasonably necessary for the support of debtor and any dependents. [8 Vermont Stat. Ann. §3706 and 12 Vermont Stat. Ann. §2740(19)(H)]

Endowment and Surrender Proceeds: Unmatured policy exempt from debts of owner and/or insured. [12 Vermont Stat. Ann. §2740(18)]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions available same as in non-bankruptcy context above.

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LIFE INSURANCE AND STATE LAWS (continued)

VIRGINIA

Death Benefits: Exempt from debts of insured and/or owner if payable to someone other than insured and/or owner. [Virginia Code Ann. §38.2-3122]

Endowment and Surrender Proceeds: Exempts cash value but not if the owner has reserved the right to change beneficiaries. [Virginia Code Ann. §38.2-3123]

Bankruptcy

Federal: Federal exemptions are not available. [Virginia Code Ann. §34-3.1]

State: State exemptions available same as in non-bankruptcy context above.

WASHINGTON

Death Benefits: Exempt from debts of insured and/or owner is payable to someone other than insured and/or owner. Also applies to debts of beneficiary. Exemptions do not apply if a claim is made against the proceeds either by the insured or the person effecting the insurance. [Rev. Code of Washington §48.18.410]

Endowment and Surrender Proceeds: Protects "proceeds and avails" on insurance contract when someone other than insured and/or owner. [Rev. Code of Washington §48.18.410] Appears to include cash surrender value of policy but not entirely clear. See *In re Elliot* 74 Wash. 2d 600, 446 P.2d 347 (1968)

Bankruptcy

Federal: Federal exemptions are allowed.

State: State exemptions available same as in non-bankruptcy context above.

WEST VIRGINIA

Death Benefits: Exempt from debts of insured if payable to someone other than insured. [W. Va. Code §33-6-27]

Endowment and Surrender Proceeds: Exempts "proceeds and avails" when beneficiary is someone other than the owner and/or insured. [W. Va. Code §33-6-27]

Bankruptcy

Federal: Federal exemptions are not available. [W. Va. Code §38-10-4]

State: Debtor exempt up to $8,000 of cash value on policy owned by debtor if debtor is insured or dependent of the insured. [W. Va. Code §38-10-4(g) and (h)]

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LIFE INSURANCE AND STATE LAWS (continued)

WISCONSIN

Death Benefits: Exempt if insuring the life of an individual of whom the debtor was a dependent to the extent reasonably necessary for the support of the debtor. [W.S.A. §815.18(3)(i)(a)]

Endowment and Surrender Proceeds: Exempt up to $150,000 if policy insures debtor's dependents or individual of whom debtor is dependent. Exemption limited to $4,000 if policy issued within 24 hours of action being filed. [W.S.A. § 815.18(3)(f)]

Bankruptcy

Federal: Federal exemptions are available.

State: State exemptions same as in non-bankruptcy context above.

WYOMING

Death Benefits: Exempt from debts of insured and/or owner if payable to someone other than insured and/or owner as well as the beneficiary. [WY ST §26-15-129]

Endowment and Surrender Proceeds: Exempt from debts of owner if someone other than debtor is beneficiary. [WY ST § 26-15-129]

Bankruptcy

Federal: Federal exemptions are not available. [WY ST §1-20-109]

State: State exemptions same as in non-bankruptcy context above.

LIFE SETTLEMENTS

The term "life settlement" generally refers to the sale to an investor of a life insurance contract when the insured is age 65 or older and *is not* terminally or chronically ill (i.e., the insured is expected to live more than two years). In contrast, the term "viatical settlement" is used to describe the sale of life insurance contract when the insured *is* terminally or chronically ill and expected to die within two years (see below). However, these terms are not consistently used, particularly in state laws and regulations. Life settlements typically require that the policy have a minimum face value of between $100,000 and $250,000, be beyond the contestability period, and be fully renewable. Policies that can be sold include term life, whole life, universal life, variable life, and survivorship life insurance. The prices paid are more than the current cash values, but less than the net death benefit.

When an application for a settlement is taken many states require that a disclosure statement be presented to the viator. (A "viator" is the owner of a life insurance policy who enters into a contract to sell the policy to a third party, usually a viatical settlement provider.) These statements typically inform the policy owner that: other alternatives may be available, such as loans and accelerated death benefits (see page 329); sale proceeds may be subject to income taxes and claims of creditors; sale proceeds may adversely affect eligibility for Medicaid and other government benefits; and the contract contains a rescission provision. The owner of the policy does not have to be the insured (e.g., a trust owned policy or a policy owned by one spouse on the life of the other spouse). Insureds should also be informed that the sale of the policy could negatively affect their ability to obtain *future* life insurance coverage, since the outstanding investor-owned policy will likely be considered in the underwriting process (see the discussion of financial underwriting on page 410).

Before selling a life insurance policy the owner should give careful consideration to the impact that the loss of the death benefit will have upon family income requirements and existing estate plans. Life settlements are most appropriately considered when *changing circumstances* cause the owner to consider surrendering a policy for its cash value. (This should be distinguished from the regrettable practice of stranger-originated life insurance that is intended to evade the insurable interest laws, see discussion on page 563.) The following are examples of those changing circumstances which can lead to life settlements: (1) business is sold and policies purchased to fund buy/sell agreement are no longer needed; (2) executive leaves business or retires and there is no need for policy intended for key person insurance; (3) premiums are no longer affordable (due to change in financial condition or failure of policy to perform as originally projected); ~~(4)~~ changing family circumstances reduce or eliminate need for insurance coverage (e.g., death of spouse, divorce or newly acquired wealth); ~~(5)~~ desire to replace individual policy with last-to-die policy; and ~~(6)~~ decrease in size of estate or increase in tax credits or exemptions

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LIFE SETTLEMENTS (continued)

result in lowered estate taxes. But, it is important to realize the investor considers the policy a good investment – meaning that it is likely in the current owners best interest to retain the policy if that is possible.

When the insured is expected to live 24 months or less the proceeds from the sale of a policy to a viatical settlement provider may be excluded from income. To obtain this favorable income tax treatment the viatical provider must be licensed in the state in which the insured resides. If the insured resides in a state not requiring such licensing, then there must be compliance with certain provisions of the Viatical Settlements Model Act (the Model Act) and requirements of the National Association of Insurance Commissioners (NAIC) relating to standards for evaluating the reasonableness of payments. To protect the viator (the individual selling the policy) the Model Act sets standards for evaluation of reasonable payments for terminally or chronically ill insureds. One alternative standard sets forth minimum percentages of the policy face that must be paid (ranging from 80 percent when the insured's life expectancy is less than six months, to 60 percent when the insured's life expectancy is at least eighteen but less than twenty five months).

Proceeds from a sale will be subject to income taxation. In Revenue Ruling 2009-13, the Service ruled that when a life insurance contract is *sold*, the cost of insurance protection must be subtracted from the net premiums paid in order to determine the owner's tax basis. The Service also ruled that a life insurance contract is a capital asset, and income recognized can qualify as long-term capital gain. (Basis is reduced by cost of insurance; the amount received in excess of basis up to cash surrender value is ordinary income; and the amount received in excess of cash surrender value is capital gain.) This ruling was not adversely applied to sales before August 26, 2009.

In an effort to regulate the sale of life insurance policies, many states have enacted statutes based upon the Model Act. In keeping with the ongoing evolution of that Act, in 2004 the NAIC voted to not require a separate viatical broker's license for certain licensed insurance producers. However, in many states life and viatical settlements are considered *securities*, their sale is formally regulated and agents must be separately licensed. Further complicating the regulatory environment is the fact that states often do not distinguish between life settlements and viatical settlements. In view of these inconsistencies, and ongoing changes in state regulation, the agent should contact the appropriate state insurance or securities departments before engaging in the solicitation or sale of life and viatical settlements. In addition, agents need to be aware that some insurers do not permit agents associated with them to promote or otherwise engage in life settlements. In some instances, such restrictions may be included in the contractual agreement between agents and insurer.

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LIFE SETTLEMENTS (continued)

In 2006, the NASD issued a notice to members reminding firms and associated persons that life settlements involving *variable* insurance policies are securities transactions subject to FINRA rules. In 2010, the Life Settlements Staff of the U.S. Securities and Exchange Commission submitted a report recommending that the definition of a security be amended by Congress to include life settlements. Their report also observed that with respect to state securities laws, 48 states now treat life settlements as securities under state laws, although some states exclude from the definition of security the original sale from the insured or the policy owner to the provider.

LIMITED LIABILITY COMPANY

The increasingly popular limited liability company (LLC) offers owners the limited liability of C corporations together with the tax and management advantages of partnerships, without the restrictions and complexities of S corporations. (However, in comparing a LLC to other business structures these advantages might be offset when state law is considered, because some states have a state corporate income tax or franchise tax which may apply to a LLC but not to an entity such as a limited partnership.) An LLC is created by filing articles of organization and complying with the relevant state law. The participants are called "members" and the rules governing the operation of an LLC are usually set forth in an "operating agreement."

The LLC form of business was first established by Wyoming in 1977 and has now been adopted by statute in all 50 states and the District of Columbia. However, the attractiveness of the LLC is often limited by the lack of uniformity between the various state statutes (e.g., some statutes contain no fiduciary duty provisions, some mirror those of partnerships, others mirror those of corporations, and still others mirror both).

The primary *advantages* of the LLC include: (1) no liability of owners for business debts (enjoyed by corporations and S corporations but not by general partnerships); (2) flow through of income and expenses to the individual owners (enjoyed by S corporations and partnerships but not by corporations); (3) the ability to allocate income and losses among members and include business liabilities in cost basis (enjoyed by partnerships but not by corporations and S corporations); and (4) freedom from the stringent requirements and restrictions of S corporations in the formation, operation and disposition of the business. For further discussions of partnerships and S corporations see the chart on page 171, pages 493-495, and pages 539-541. It has also been suggested that the LLC could serve as a viable alternative to the irrevocable life insurance trust, by affording the insured greater control and flexibility, in much the same way as the limited partnership (see discussion, page 491). Members of an LLC that has elected to be taxed as a partnership are treated as partners for many (but not all) tax purposes, such as the transfer-for-value rule exception under IRC §101(a)(2)(B).

An LLC formed *after* December 31, 1996, will generally be taxed as a partnership if it has more than two owners, or as a sole proprietorship if it has only one owner, unless it elects to be taxed as a corporation. This election can be made under the "check the box" regulations by filing Form 8832 (Entity Classification Election). An LLC formed *before* January 1, 1997, will generally be treated as it was prior to January 1, 1997, unless it elects otherwise.

LIMITED LIABILITY COMPANY (LLC) V. ILIT AS LIFE INSURANCE OWNERSHIP STRUCTURE

The increasingly popular limited liability company (LLC) offers owners the limited personal liability of C corporations together with the tax and management advantages of partnerships, without the restrictions and complexities of S corporations (see summary of the LLC on page 464).

Because of the flexibilities of an LLC, they are often promoted as an alternative to an irrevocable life insurance trust (ILIT). While this may be a generally true analysis, the comparison of the LLC and ILIT is often not complete. Specifically, those comparing an LLC and an ILIT do not always consider the flexibilities that can be put into today's irrevocable trusts. Moreover, the law on LLCs funded exclusively or primarily with life insurance is not well developed – leaving significant uncertainties. Because LLCs are creations of state law, there is a lack of uniformity among the relevant statutes of the many jurisdictions, which necessarily makes the analysis, and potentially the choice, different in each state.

The common approach to ownership of life insurance by an LLC is usually to purchase the life insurance policy with cash provided by the insured to the LLC. The insured's contribution to the LLC is not a gift because the contribution is a contribution to the capital of the LLC as consideration for an ownership interest. The LLC organizational document ordinarily contains restrictions on distributions and transferability. These restrictions can have the dual benefit of restricting the value of the interest (i.e., creating valuation discounts) and protecting family members from creditors (much like an ILIT).

The insured can then transfer LLC interests to children or trusts for children (or Dynasty Trusts) through gift or by sale. The LLC interests are often transferred at a discount – sometimes in the 30% to 40% range. (See "Family Limited Partnerships" for a discussion of valuation discounts.) With the $5,430,000 lifetime gift tax exemption it is often easy to transfer most or all of the LLC interests shortly after issue. In some situations, the interests are transferred over time under the $14,000 annual gift tax exclusion. Unlike an ILIT, these annual exclusion gifts of LLC interests should not require Crummey notices (See Crummey Powers at page 368) or the associated holding period. However, gifts of LLC interests may require a professional appraisal. The insured retains management control in the LLC – usually with ownership of a small percentage of the LLC units.

It is believed that the LLC is more flexible than the ILIT because the insured has retained management control of the LLC and can terminate the LLC or amend the LLC if the family situation changes. It is also believed that upon termination of the LLC that the insured can direct distribution of the LLC assets – thus determining who is in receipt of the life insurance policy. Any transfer of the policy to a member of the LLC should avoid the transfer for value rules because the LLC is treated as a partnership for income tax purposes. As a partnership, the transfer of the policy is treated as a transfer to a partner of the insured. (See Transfer for Value at pages 573-574).

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LIMITED LIABILITY COMPANY (LLC) V. ILIT AS LIFE INSURANCE OWNERSHIP STRUCTURE (continued)

It seems that in many instances, the biggest perceived advantage of an LLC over an ILIT is that the insured can retain control over the life insurance contact on his or her own life by having the right to make decisions for the policyholder – the LLC. So, it is believed, that the insured may only have 1% of the life insurance included in his or her estate (through the retained LLC interest), yet the insured can make important insurance decisions. Some of the decisions that the policyholder can make (i.e., the insured as manager of the LLC) are: (1) maintain or surrender the policy, (2) investment of policy cash surrender values (with a variable type policy), (3) withdrawals and loans from a cash value policy, (4) conversion of a term policy, and (5) life settlements.

The possible disadvantages to an LLC ownership of life insurance, however, include unforeseen state income and franchise taxes. A number of states have income and franchise taxes that apply to an LLC that do not apply to an ILIT. Most importantly, however, some tax professionals remain unconvinced that an insured can enjoy all of the powers over the life insurance policy as manager of an LLC without estate tax inclusion of the policy. Clearly, IRC Section 2042 prohibits the retention of "incidents of ownership" in a life insurance contract. Because of Section 2042, it is known that an insured cannot ordinarily serve as the trustee of an ILIT that owns a policy on his or her own life. Some tax advisors continue to wonder if Section 2042 can really be avoided by having the policy owned in an LLC instead of a trust. Does the insured's right to surrender the policy, withdrawal cash, change investment strategies, direct distribution of the policy among LLC owners upon termination of the LLC really not cause estate tax inclusion because the policy is owned in an LLC? Those same powers, if held in a fiduciary capacity as trustee of an ILIT, would cause inclusion in the insured/trustee's estate. However, in *Estate of Knipp*, the Court held that the death benefit of a *partnership-owned* life insurance policy was not includible in the insured partner's life if the death benefit was payable to the partnership.

In a corporate context the law seems well resolved that a minority shareholder does not have incidents of ownership just because the insured is the one actually managing the day to day affairs of the business. On the other hand, a controlling shareholder is treated as having any incidents of ownership over life insurance contracts owned by the corporation. Is the insured retaining a minority interest only in an LLC like a minority shareholder in an ordinary business situation? What if the LLC owns only the life insurance contact? Could the IRS make a form over substance argument (See Step Transaction Doctrine at page 560). Some advisors feel that an LLC holding few assets other than a life insurance contact could be viewed differently than an active business which happens to own an insurance contact.

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LIMITED LIABILITY COMPANY (LLC) V. ILIT AS LIFE INSURANCE OWNERSHIP STRUCTURE (continued)

Many people, including advisors, view ILITs as inflexible. However, when comparing an ILIT to an LLC, the flexible provisions common today in ILITs should not be ignored. It is possible for the family (not the insured) to retain access to policy values through use of the so-called Spousal Access Trust (See page 559). Many states allow for liberal modification of irrevocable trust terms through a process known as "decanting" (See page 370). Trust protector powers can be used to check the powers of trustees and help insure that the trustee is acting in the best interest of the trust beneficiaries (See page 575). ILITs enjoy considerable creditor protection – in many states greater than protections afforded to LLC interests. An ILIT can give the trustee very flexible powers during the insured's lifetime to make distributions of policy cash values to trust beneficiaries. The right to make distributions can be spelled out in very creative ways. One of the ways in which trust distribution provisions is kept flexible is through the so-called "Incentive Trust" (see page 421).

In summary, the LLC is a popular and powerful planning tool. It provides flexibility, creditor protection, and possible valuation discounts. Although the LLC may have some advantages over the traditional ILIT when it comes to life insurance planning, it is important to consider the advantages and disadvantages carefully. Probably the biggest question being – does possible additional flexibility outweigh the seemingly yet unresolved estate tax issues? Today, ILITs need not be inflexible. State of the art trust drafting and liberal state trust laws make today's ILITs far more flexible than imagined not that many years ago.

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LIVING WILL

The living will is a legal document that allows an individual to state in advance his or her unwillingness to be subjected to life-sustaining medical measures once there is no chance of recovery. Such a document relieves others of the legal and emotional burden of making such decisions.

For example, it can ease a doctor's fears of civil or criminal liability, since the doctor is abiding by the patient's wishes in withholding or withdrawing life-prolonging treatment. It can ease the stress and emotional pain for the family, which might otherwise be faced with having to make a most difficult decision as to what their loved one would have wanted. Further, it offers some hope of avoiding the legal battles that have occurred when a medical facility is unsure of its responsibility to the patient, and thus provides the family some protection from the financial devastation that a protracted death can cause.

Almost all of the states have some form of legislation governing living wills. Generally such a document must be in writing, dated, and witnessed by two persons who are not family members or possible heirs. The document must usually be notarized if a durable power of attorney is included giving another person the power to make medical treatment decisions (see discussion, page 386). In addition, language can be included providing for organ donation.

Copies of the living will should be given to close relatives, the family doctor and the family attorney. Both the living will and the durable power of attorney can be revoked at any time by either destroying all copies or by executing a signed and notarized statement revoking the prior document.

See also, Health Care Power Of Attorney, page 419.

LONG-TERM CARE COMBINATION PRODUCTS

The risk of needing long-term care (LTC) is substantial and the costs of providing such care can be overwhelming (see chart on page 261). According to a recent Boston Globe article on long-term care insurance the cost of a home health aid in Massachusetts was more than $55,000 per year in 2012 and the cost of a semi-private room in a nursing home was over $110,000. Because of the rapid increase in the cost of nursing care, the benefits paid out by long-term care insurance carriers has sky-rocketed from $3.5 billion in 2007 to $6.6 billion in 2012. As a result, premiums on both new and existing long-term care products have also increased substantially. For example, the cost of long term care insurance on a 55 year-old couple has increased from less than $2,000 per year in 2007 to nearly $3,500 per year in 2012. In fact, partly because of the unpredictable cost of long-term care services, a number of insurance companies have stopped selling stand alone long-term care coverage – allowing for further price increases by the relatively few remaining companies selling this protection.

Despite the need for long-term care insurance, sales of the stand-alone LTC insurance products have been negatively impacted by increasing product costs and the client's fears of paying premiums for a product from which they will never derive a benefit (i.e., the fear of "use it or lose it"). As a result, insurance companies are increasingly offering hybrid or so-called combination or living benefit products These products address both consumer fears of uncontrollable premium increases and paying for a product they will not use.

With a cash value life insurance policy the death benefits can be accelerated to make either per diem payments or expense reimbursements upon the insured's disability or chronic illness. A rider is often added to provide additional coverage in order to extend the LTC benefits once the contract cash values and death benefits had been exhausted. This effectively allows the consumer to purchase at an attractive cost one policy to insure against two risks. However, it must be recognized that LTC payments from the contract could reduce or even eliminate the life insurance death benefit. (The use of cash values and death benefits for LTC payments is considered a form of "self-funding.") The accelerated benefit, whether paid from the net amount at risk or from the rider providing separate LTC coverage, will be entitled to favorable tax treatment provided the contract is a "*qualified* long-term care insurance contract" (QLTCI). See discussion on page 517. Charges against policy cash values are not taxable even if there is gain in the contract. The cost of adding an LTC or chronic illness rider to a life insurance contact is often less than 15% of the life insurance only premium. The cost of the rider can be priced reasonably because the insurance company is already pricing for the death benefit – meaning that early payout for LTC or chronic illness costs is only a "timing difference."

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LONG-TERM CARE COMBINATION PRODUCTS (continued)

Not all riders are equal, however. Some riders are structured as true LTC riders while others are structured as "chronic illness riders." LTC riders, with the classification of 7702B, require a physician to certify that the insured, for a period of at least 90 days, is unable to perform at least two Activities of Daily Living (ADLs) or suffers from severe cognitive impairment. This definition allows for certain temporary claims as well as permanent claims to be covered. True LTC riders are available for an additional charge and require underwriting. LTC underwriting focuses on morbidity risk rather than mortality risk meaning that not all people who can medically qualify for life insurance will qualify for the LTC rider.

The main differentiator among 7702B LTC riders is whether the rider pays by an indemnity model or reimbursement model. Reimbursement plans, no matter what the stated maximum benefit is, will never pay more than the qualifying LTC expenses incurred. Qualifying expenses in reimbursement plans do not include the costs of home modification, medical equipment and other potential expenses that go along with LTC needs.

Indemnity plans pay the maximum benefit the policy allows, regardless of actual expenses. No bills or receipts are needed to justify the cost of care. An indemnity plan can thus provide payment to the insured's family whereas that is usually not possible with a reimbursement type rider.

Some riders are classified as 101(g) only. These riders use the indemnity model of benefit payment. However, the term "long-term care" may *not* be used in marketing these products. These riders, usually referred to as "chronic illness riders," differ from LTC riders in that the physician must certify the chronic illness is likely to last the rest of the insured's life. For this reason, temporary conditions would not be eligible for claim. Although this seems like a significant difference, many LTC riders have "exclusionary periods" providing that benefits can only be accessed after a significant waiting period, thus, minimizing much of the benefit sometimes attributed to LTC type riders.

A main differentiator among chronic illness riders is whether the rider is paid for by an additional charge added to the policy (like a LTC rider) or is included as a policy feature with no underwriting. While a "free" chronic illness rider may sound like an advantage, these riders are essentially paid for at the time of claim making them often less efficient than LTC or chronic illness riders paid for by an additional charge.

Life insurance with LTC or chronic illness riders have become very popular products, largely because of the sky-rocketing cost of LTC care and the uncertainty of stand-alone LTC product pricing. Carriers often promote their rider as "the best." In reality, "best" largely depends upon circumstances. It is important for advisors to understand the differences between true LTC riders and chronic illness riders. It is also important to understand the differences between indemnity and reimbursement type arrangements. In essence, like all life insurance decisions, it is simply important to understand the product features and costs in light of the insured and the family circumstances.

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LONG-TERM CARE COMBINATION PRODUCTS (continued)

With a **non-qualified annuity** LTC benefits can be paid from a tax-qualified LTC rider provided the rider complies with the requirements of a QLTCI. Benefits received after January 1, 2010 are entitled to favorable tax treatment (see page 517). Such coupling of a LTC rider with a non-qualified annuity provides a unique opportunity to use a non-qualified annuity for LTC needs since this favorable tax treatment is available even though the benefit payment reduces the annuity contract's cash values (i.e., untaxed inside buildup within the annuity may be paid out tax-free for LTC expenses).

Both life insurance and non-qualified annuities can be exchanged tax-free under Section 1035 for a QLTCI (see page 568). This would allow for an exchange of an existing life policy that has outlived its purpose into a combination life/LTC plan (i.e., gain in the policy would not be subject to current taxation). Likewise, one QLTCI can be exchanged for another QLTCI.

PLANNING WITH LONG-TERM CARE COMBINATION PRODUCTS can add flexibility to a client's future financial options. Many clients prefer to own the product outright, to maintain control and facilitate the payment of benefits. Most products allow the owner to elect to have the benefits paid directly to the caregiver or to the owner. However, some clients choose to have the product insuring their lives owned by a third-party owner, such as a family member or a trust. If the product issuer allows third-party ownership, and also permits payment to the owner instead of directly to the caregiver, then such an arrangement can serve to accelerate the death benefit while reducing the taxable estate of the insured.

When the insured qualifies for benefits under the provisions of the product, the third-party owner of the product receives the payment of the benefits, not the insured or the caregiver. However, the insured will pay for the care from his or her own funds, thereby reducing the taxable estate. The benefits, received by the third-party owner, are available for whatever use or investment the owner desires. It is well to note that the use of such arrangements is very new and not clearly anticipated by the laws governing the taxation of long-term care combination products. Some risk exists that the use of these products in such arrangements will not be found to enjoy the same tax benefits as more conventional ownership arrangements.

MANAGED CARE

Managed care is a comprehensive approach to health care with the intent of lowering costs by arranging for care at predetermined or discounted rates, specifying which doctors and hospitals the patient can use and overseeing physicians' treatments and referrals. The basic variations of managed care plans include:

1. **Health Maintenance Organization (HMO):** A health plan that combines coverages of health-care costs and delivery of health care for a prepaid premium. Members receive services from individuals employed by or under contract to the HMO. HMOs generally require patients to select a primary-care physician (PCP) who coordinates the patient's care. Patients usually need referrals from the PCP before going to a specialist or a hospital. The PCP is often referred to as a ''gatekeeper.'' In return for accepting these restrictions, patients are relieved of deductible or coinsurance payments and copayments are typically only $10 to $20 per visit to the doctor. This is in contrast to the traditional major medical plan or fee-for-service plan under which patients can choose both their doctors and hospitals, but must pay 20 percent of the costs (subject to caps). In HMOs the direct relationship between the financing and delivery of health care has generated criticism of: (1) the existence of ''gag rules'' that prohibit physicians from discussing all possible treatment options with patients; (2) the denial of access to specialists; (3) the denial of reimbursements for emergency room charges in hospitals outside the plan; (4) limits placed on hospital stays for certain procedures; and (5) treatment decisions designed to save money and adverse to the patient's health.

2. **Point-Of-Service (POS):** A managed-care option that allows members to seek care outside the HMO network, but at a higher cost (usually in the form of higher premiums, co-payments, and deductibles).

3. **Preferred Provider Organization (PPO):** A network of independent physicians, hospitals, and other healthcare providers who contract with insurance companies to provide care at discounted rates. Members are given incentives to use the PPO physicians but for a higher cost are allowed to use doctors and hospitals outside the network. This is also referred to as a ''managed indemnity'' plan.

MARITAL DEDUCTION

By taking advantage of the marital deduction, unlimited amounts of property can be passed between spouses, during lifetime or at death, free of gift taxes and estate taxes. However, the marital deduction is generally not allowed if the property represents a terminable interest (i.e., an ownership right that will come to an end after a period of time or upon the occurrence of some specified event in the future).

The marital deduction can be obtained through the use of any of the following techniques:

1. **Outright transfer** – passes property directly to the surviving spouse. This can be accomplished in a variety of ways, including: joint ownership with rights of survivorship; beneficiary designation; bequest or devise; inheritance; and dower or curtesy (or under state intestate succession laws).

2. **Power of appointment trust** – gives the surviving spouse a right to all income for life and a general power of appointment over the trust assets (i.e., the unlimited right to withdraw property during lifetime or appoint property at death). In the chart on page 25, the "A" trust represents a power of appointment trust, which is also referred to as a "marital deduction trust." An expanded discussion of "general power of appointment" is contained on page 505.

3. **QTIP trust** – gives the surviving spouse a right to all income for life, with principal to children, or others, upon death of the surviving spouse. The primary advantage of the QTIP arrangement is that the *first* spouse to die controls who gets QTIP trust assets following the death of the surviving spouse while still qualifying the transfer to the QTIP trust for the unlimited marital deduction. Thus, QTIP trusts are an exception to the terminable interest rule. The executor or executrix must make the QTIP election. Property placed in a QTIP trust is subject to estate taxation in the surviving spouse's estate. See the discussion and chart on pages 34-35.

4. **Estate trust** – can accumulate income without payments to the surviving spouse, but must be paid to the estate of the surviving spouse (i.e., surviving spouse determines who eventually receives property placed in this trust, plus any accumulated income).

5. **Qualified domestic trust** – assures collection of the federal estate tax when the surviving spouse is a non-citizen. An expanded discussion is contained on page 516.

Terms & Concepts

MEDICAID

This state-run public assistance program provides medical benefits to groups of low-income people, some who may have no medical insurance or inadequate medical insurance. Although the federal government establishes general guidelines for the program, the Medicaid program requirements are actually established by each State. A State is required to include certain types of individuals or eligibility groups under its Medicaid plan and the plan may include others. States' eligibility groups include: *categorically needy* such as Supplemental Security Income (SSI) recipients, *medically needy* such as blind persons, and *special groups* such as community Long Term Care services for individuals who are Medicaid eligible and qualify for institutional care.

Qualifying For Medicaid. Basic to qualifying for Medicaid assistance is the requirement that applicants do not have sufficient *income* to provide for their own care. Most states permit individuals with excess income to qualify for Medicaid, provided they "spend down" this income by incurring medical expenses (but some "income cap" states deny benefits whenever there is excess income). Medicaid qualification also requires that the applicant have very limited amounts of personal *resources* (spousal impoverishment rules allow a non-institutionalized spouse to maintain separate property). In 2015 home equity that is exempt is limited to $~~536,000~~, although states may raise this to $~~802,000~~. See also, page 477. There is no limit for homes occupied by a stay-at-home spouse (referred to as a "community spouse"). To discourage applicants from making transfers for inadequate consideration, transfers during a "look-back" period can delay eligibility for a period equal to the amount of the transfers divided by the average costs to a private patient in a nursing facility in the state.

(1) **Transfers prior to February 8, 2006.** The look-back period is the *36 months* before application for Medicaid benefits, and any penalty begins to run the *month after* the transfer is made (in some states the penalty begins to run in the month of transfer). For example, assume a Medicaid applicant transferred to his children by gift a home valued at $140,000 in June of 2003. If the average cost for nursing home care was $3,500, the period of ineligibility for Medicaid would be 40 months ($140,000 ÷ $3,500 = 40). This period begins to run in July of 2003. If the applicant entered a nursing home on February 1, 2006, he would have to pay for the first 9 months of care (July 2003 through January 2006 = 31 months; 40 - 31 = 9).

(2) **Transfers on and after February 8, 2006.** The look-back period is the *60 months* before application for Medicaid benefits, and any penalty begins to run the *later of* the date of the transfer, or the date of first possible eligibility for Medicaid. Again, assume a Medicaid applicant transfers a gift to his children in June of 2008, and the ineligibility period is 40 months. If the applicant enters a nursing home on February 1, 2013, he would have to pay for the first 40 months of care after financially qualifying for Medicaid (i.e., there is no prior tolling of the ineligibility period).

MEDICAID PLANNING

Medicaid long-term care benefits require that an institutionalized individual can have countable assets of no more than $2,000. If married, the non-institutionalized spouse can retain countable assets within limits set by the Federal government (the specific amount varies from state to state, but was limited to a maximum of $117,240 in 2014). Countable assets include virtually all investments, savings, and real estate owned by the applicant and his or her spouse. See also, page 474.

Annuities. An immediate annuity can be used as a means of transforming "countable" assets into an income stream that does not affect Medicaid eligibility. To qualify the annuity must be: (1) irrevocable – periodic payments cannot be changed, (2) non-transferable – benefits cannot be changed to another beneficiary, (3) "actuarially sound" – a term certain annuity cannot be payable for longer than the annuitant's actuarial life expectancy; and (4) the state must be named the first remainder beneficiary up to the amount of Medicaid benefits paid on the annuitant's behalf (if a surviving spouse or blind or disabled child is named as the primary beneficiary, then the state may be named the secondary beneficiary).

Purchase of life estate. The purchase of a life estate is not considered a transfer of assets provided the purchaser resides in the home for a period of at least one year after the date of purchase (e.g., father living in son's home purchases from the son a life estate in the home, lives there for at least one year, and then enters a nursing home). This transforms a countable resource (cash) into a non-countable resource (the life estate), provided payment for the life estate does not exceed its fair market value as calculated in accordance with certain tables. Before entering into such an arrangement the capital gains tax consequences to both the parent and the child should be carefully considered (e.g., potential elimination of capital gains tax exemption upon a subsequent sale of the home).

Transfer in trust for disabled child. Transfers to a supplemental needs trust for the "sole benefit" of the applicant's permanently and totally disabled (or blind) child do not affect Medicaid eligibility (see page 557).

Planning for the home. The value of the applicant's home is important in determining eligibility for Medicaid benefits to pay the costs of long-term care. Home equity that is exempt was limited in 2014 to $543,000, although states could raise this to $814,000. However, this limitation on home equity does not apply if any of the following persons reside in the home: (1) the individual's spouse; (2) the individual's child under 21; (3) the individual's blind or disabled child; (4) a sibling who has an ownership interest in the home and was residing in the home for a period of at least one year immediately before the individual became institutionalized; or (5) a caregiver child who resided in the home for a period of at least two years immediately before the individual became institutionalized and whose care permitted such individual to reside at home. Further, Medicaid eligibility is not compromised if the individual receiving Medicaid *transfers* the home to any of these same people (e.g., the home is given to the caregiver child). Once transferred, the home is no longer subject to a Medicare reimbursement claim, as such claim can only be asserted against the recipient's estate.

MEDICAL INFORMATION BUREAU

The Medical Information Bureau (MIB) is a nonprofit trade association of over 700 life insurance companies that was first organized in 1902 to conduct a confidential interchange of underwriting information among its members as an alert against fraud. This interchange enables MIB member companies to protect the interests of both insurance consumers and life and health insurance providers. MIB's basic purpose is to detect and deter fraud and misrepresentation in connection with the underwriting of life and health insurance and claims.

Upon receipt of an application accompanied by a suitable authorization, member companies conduct a search of MIB records as part of their usual underwriting procedure. Members are also required to report relevant results of their underwriting evaluation to the MIB; that is, of conditions that are significant to health or longevity. Both favorable and unfavorable medical information is reported. Certain nonmedical information of a very restricted nature regarding insurability is also reported (e.g., confirmed adverse driving record, hazardous sports activity and aviation activity). In order to help preserve confidentiality the information is reported and maintained in code symbols. Members may not report codes based on claim information.

MIB information is used only to alert member companies to the possible need for further information. It *may not* be used as a basis for establishing eligibility for insurance. An MIB report does not indicate the underwriting action of the reporting company or the amount of coverage applied for.

Only member companies have access to MIB information and then only after receiving written authorization from the proposed insured in the course of the application process. The proposed insured's spouse cannot give this authorization. MIB information is not released to nonmember companies, credit or consumer reporting agencies, or governmental agencies, except pursuant to court order or authorization from the consumer.

The consumer who applies for life, health, or disability insurance receives a brief written notice that describes MIB and its function. In addition, this notice tells how the consumer can access and correct his MIB record when needed. To obtain a copy of their MIB record, if one exists, or to seek correction of the MIB record, consumers can contact the MIB toll-free at 866-692-6901. Their web site is located at www.mib.com.

MEDICARE

Medicare is a federal health insurance program for persons 65 or older, persons of any age with permanent kidney failure, and certain disabled persons. The program is administered by the Centers for Medicare & Medicaid Services (CMS). Medicare claims are processed and paid by various commercial insurance companies under contract with CMS.

Part A – Hospital Insurance protection provides institutional care, including inpatient hospital care, skilled nursing home care, post-hospital home health care, and, under certain circumstances, hospice care.

(a) **Enrollment.** Any person eligible for Social Security monthly benefits is automatically eligible for Hospital Insurance protection, beginning with the first day of the month in which the person turns age 65. An individual who is *already receiving* Social Security monthly benefits need not file again to receive Medicare Part A benefits. A person *eligible for, but not yet receiving*, Social Security monthly benefits may apply separately for Medicare Part A benefits. Most retired individuals pay no Part A premium (see premium summary on page 479).

(b) **Coverage.** For the first 60 days, all covered hospital expenses are paid in full except for an initial inpatient deductible ($~~1,216~~ in ~~2014~~). For the next 30 days, the patient must pay a daily coinsurance charge ($~~304~~ per day in ~~2014~~). Thereafter, the patient has available an additional lifetime reserve of 60 hospital days, during which the patient must pay a daily coinsurance charge ($~~608~~ per day in ~~2014~~). Skilled nursing facility care, home health care, and hospice care, are also covered, but intermediate and *custodial care* are not covered. Beyond 150 days there is no coverage. See benefits summary on page 480.

Part B – Medical Insurance protection is a voluntary program of health insurance, which covers physician services, outpatient hospital care, physical therapy, ambulance trips, medical equipment, prosthetics, and a number of other services not covered under Part A. This is also known as "Supplementary Medical Insurance (SMI)."

(a) **Enrollment.** Those who are receiving Social Security benefits are enrolled automatically at the time they become entitled to Hospital Insurance, unless they elect not to be covered for Medical Insurance. For persons born after 1938 normal retirement age is not age 65 (see page 316). These persons must enroll before the beginning of the month in which age 65 is reached, in order to obtain coverage at the earliest possible date (unless they have elected early retirement, in which case they are enrolled automatically). See premium summary on page 479.

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MEDICARE (continued)

(b) **Coverage.** Medical Insurance helps pay for covered services received from a doctor in the doctor's office, in a hospital, in a skilled nursing facility, in the patient's home, or any other location. After the patient pays the first $147 of covered services in each calendar year, Medicare usually pays 80 percent of the approved charges for doctors' services and the cost of other services. See benefits summary on page 480. Medical Insurance under Medicare *does not cover*: (1) most routine physical examinations and tests directly related to such examinations; (2) most routine foot care and dental care; (3) examinations for prescribing or fitting eyeglasses or hearing aids, and most eyeglasses and hearing aids; (4) immunizations (except annual flu shots and limited vaccinations for certain persons at risk); (5) most cosmetic surgery; and (6) custodial care at home or in a nursing home. (Although Medicare does provide a limited benefit for home health care, it is the Medicaid system that provides for nursing home care.)

Part C – Medicare Advantage, previously known as Medicare+Choice, permits contracts between CMS and a variety of different managed care and fee-for-service organizations. These plans must provide all current Medicare-covered items and services, and they may incorporate extra benefits in a basic package, or they may offer supplemental benefits priced separately from the basic package. Most Medicare beneficiaries can choose to receive benefits through the original Medicare fee-for-service program, or through a coordinated care plan (including Health Maintenance Organizations (HMOs), Preferred Provider Organizations (PPOs), and Provider-Sponsored Organizations (PSOs)), or a private fee-for-service plan that reimburses providers on a fee-for-service basis.

Part D – Prescription drug plans, provides a comprehensive voluntary prescription drug benefit available to everyone with Medicare. The plans are provided by insurance companies and other private companies approved by Medicare. Coverage is available under stand-alone plans, or through Medicare Advantage plans that integrate with health care coverage provided under Part C of Medicare. In ~~2014~~ the average basic premium is about $31 a month.

(a) **Enrollment.** There is an opportunity to enroll when joining Medicare, or during an annual open enrollment period running from November 15th to December 31st. Although enrollment is optional, those who fail to enroll will pay a penalty of about 1 percent for each month of delay (e.g., delaying enrollment for 14 months will result in a 14 percent lifetime increase in premiums). Persons who have prescription drug coverage "at least as good" as the basic plan (see next paragraph) will not incur a penalty. However, not all drugs are available in every plan.

In selecting a plan the enrollee must balance the three Cs of cost, coverage, and convenience. For example, plans may charge a higher monthly premium in return for enhanced coverage offering

(continued on next page)

MEDICARE (continued)

a greater selection of drugs (set out in a "formulary"), lower deductibles, lower co-pays, and greater geographic coverage. Plan selection has been made difficult by the sheer number and variety of plans offered. A drug finder program can be found at www.medicare.gov.

(b) **Coverage.** All plans must provide coverage "at least as good" as the standard coverage set by Medicare. In ~~2014~~, under standard coverage, once the enrollee has paid a $~~325~~ annual deductible, the enrollee pays 25 percent and Medicare pays 75 percent of drugs costs on the next ~~$2,970~~. The enrollee then pays ~~79~~ percent for generic drugs and ~~47.5~~ percent for brand name drugs on the next $~~3,763.75~~ (this represents the continued phase out of the donut hole coverage gap under The Patient Protection and Affordable Care Act of 2010). Thereafter, the enrollee pays 5 percent, and Medicare pays 95 percent of drug costs. Plans cover both generic and brand-name drugs. Low-income subsidies provide for no gap in coverage, and reduce, or eliminate, premiums, deductibles, and co-payments.

For those individuals who have retiree prescription drug benefits from their employers, substantial direct subsidies, and tax benefits, are offered to employers who maintain drug coverage for retired workers. The previous Medicare-approved drug discount cards have been phased out.

Premium Summary

~~2014~~

HOSPITAL (Part A)

Monthly Premium*	Quarters of Medicare-Covered Employment
$0	40 or more
$~~213~~	30-39
$~~446~~	less than 30 (and not otherwise eligible for premium-free hospital insurance)

MEDICAL (Part B)

Monthly Premium	Income Of Beneficiaries Who File: Married Filing Jointly		Married Filing Separately		Other Than Married	
	Over	To	Over	To	Over	To
$104.90	0	170,000	0	85,000	0	85,000
$146.90	170,000	214,000	-	-	85,000	107,000
$209.80	214,000	320,000	-	-	107,000	160,000
$272.70	320,000	428,000	85,000	129,000	160,000	214,000
$335.70	428,000	-	129,000	-	214,000	-

* Most retired individuals pay no Part A premium.

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MEDICARE (continued)

Benefits Summary

~~2014~~

HOSPITAL (Part A)	Benefit	Individual Pays	Medicare Pays
Hospitalization	first 60 days	$~~1, 216~~	balance
	61st to 90th day	$~~304~~ a day	balance
	91st to 150th day	$~~608~~ a day	balance
	beyond 150 days	all costs	nothing
Skilled Nursing Facility Care	first 20 days	nothing	all (as approved)
	next 80 days	$~~152~~ a day	balance
	beyond 100 days	all	nothing
Home Health Care	first 100 days in spell of illness	nothing for services 20% for durable medical equipment	all balance
Hospice Care	unlimited (doctor must certify)	outpatient drugs and inpatient respite care	balance
MEDICAL (Part B)			
Medical Expenses	unlimited	$147 deductible plus 20% of remaining	balance
Clinical Laboratory Services	unlimited	nothing	all
Home Health Care	unlimited (but covers only what is not covered under Part A)	nothing for services 20% for equipment	all balance
Outpatient Hospital Treatment	unlimited	$147 deductible plus 20% of remaining	balance

Benefits must be medically necessary. Under Part A hospitalization benefits from 91st to 150th day are the 60 “reserve” days that may be used only once in a lifetime.

MINIMUM DEPOSIT INSURANCE

Minimum deposit insurance is not a particular type of life insurance contract. It is a method of paying premiums using policy loans. (In contrast, see the discussion of Premium Financing on page 506.)

Because consumer interest is not deductible, minimum deposit insurance is unattractive for most individual policy owners. Nevertheless, within strict limits a business (including a corporation, partnership, or sole proprietorship) can deduct interest payments that are reasonable business expenses on a policy that is "tax qualified." This deduction is limited to loan interest paid on policies insuring a "key person" for up to $50,000 of indebtedness. A key person is an officer or a 20-percent owner of the business. The number of individuals who may be treated as key persons is limited to the greater of: (1) five persons; or (2) the lesser of five percent of the total officers and employees or 20 individuals (i.e., no more than 20 persons can be treated as key persons).

In addition, interest in excess of an "applicable rate" cannot be deducted (referred to as an interest rate "cap"). The applicable rate is that rate described in Moody's Corporate Bond Yield Average - Monthly Average Corporates, as published by Moody's Investors Service.

Except for application of a modified interest rate cap, contracts issued prior to June 21, 1986, are "grandfathered" (e.g., they are not subject to the key person provisions described above). Loans taken on nongrandfathered policies before 1996 are subject to a phase-in of the disallowance of the interest deduction. No deduction is allowed for the part of the taxpayer's interest expense which is "allocable to unborrowed policy cash values," which are defined as the excess of the cash surrender values (determined without regard to surrender charges) over the amount of any policy loans. However, there is an exception which applies to policies and contracts owned by entities if the policy covers only one individual who, at the time first covered by the policy, is: (1) a 20-percent-owner of the entity; or (2) an individual who is an officer, director or employee of the trade or business. See **Q 31**, *Tax Facts on Insurance & Employee Benefits (2015)* for a more complete explanation of the above limits on policy loan interest.

Most plans of minimum deposit insurance can be best explained as follows: (1) cash values are borrowed at a relatively low rate of interest; (2) borrowed cash values are used to pay premiums; (3) if any 4 out of the first 7 years' premiums are paid from unborrowed funds and borrowing in the other 3 years does not exceed the annual premiums, the policy is considered "tax qualified" and the interest paid on the borrowed cash values is deductible within the limits established under IRS regulations; (4) if the interest is deductible, after-tax cost is reduced; (5) if desired, beginning in the 8th year, both the premium and the after-tax cost of interest payments can be borrowed.

MINORS AND IRAs

IRA established for a minor. If a minor has earned income, the minor can have his or her own IRA (federal law has no age requirement). State law determines whether the financial institution is able to contract direct with a minor. If the minor cannot directly open an account, then the IRA can be established by a custodian under a custodial account (see Uniform Transfers/Uniform Gifts To Minors Acts, page 580). An IRA can also be established by a court appointed guardian, but this can be both timely and costly. When either a custodial account or guardianship is used, it must be accepted that the minor will have legal title to the IRA upon attaining the age of majority (this varies from 18 to 21 years of age depending upon the state). Typically this may not a major disadvantage, since the account is likely to have only modest value.

Minor as beneficiary of inherited IRA. A minor can also be named the primary or contingent beneficiary of another individual's IRA account (e.g., in the parent's IRA the spouse is named the primary beneficiary and a minor child is named the contingent beneficiary). As with an IRA established for the minor, either a custodial account or a guardianship arrangement can be used with an inherited IRA. However, the arrangement terminates once the beneficiary has reached the age of majority and there is no control as to how the funds are spent. This can be a major disadvantage, since inherited IRAs often have substantial value.

With a trust the grantor can prevent the minor from having access to the entire value of the IRA, until such time as determined by the grantor. However, the grantor cannot delay all distributions to the minor. Unlike the IRA account holder who can delay required minimum distributions (RMDs) until age 70½, minors who are IRA beneficiaries must take RMDs each year following the account holder's death. Because minors have relatively long life expectancies, the amounts of these yearly distributions are very low, with the result that the bulk of the account can continue to grow tax-deferred for many years (with the Roth IRA this growth is *tax-free*).

Keeping these distributions low requires that the RMD calculation be based upon the minor's life (or at least upon the life of a relatively young individual). To accomplish this it is important that the trust contain very specific language and the trust beneficiaries be limited, otherwise it is possible that the trust could be forced to make all distributions within as little as five years of the IRA owner's death (i.e. there would be no opportunity to make "stretch distributions" to the minor over his or her lifetime). See the discussion of See-Through Trust on page 549.

MINORS AND LIFE INSURANCE

Insurance companies will not knowingly accept a minor as the direct owner or beneficiary of a life insurance contract (for minor as insured, see page 350). Although trusts provide the most flexible way of managing policies and proceeds, establishing and administering them involves both time and expense. Policy ownership and beneficiary arrangements involving minors are governed by either the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA) (see page 580). Other than South Carolina and Vermont, where the older and more restrictive UGMA is still in effect, all states have statutes based upon the UTMA. But, despite the general adoption of UTMA by most states, it is important to consult individual state laws, since states typically alter the text of the uniform versions.

If the beneficiary designation includes a custodial nomination, the proceeds can be transferred to a custodian without appointing a guardian. Any trust company or adult other than the insured can be nominated custodian (an adult under state UTMAs is usually age 21). A designation paying a death benefit to a child of the insured might read: "[name of child], child of the insured; provided that if any proceeds become payable when [name of child] is a minor as defined in the [state] Uniform Transfers to Minors Act, such proceeds shall be paid to [name of adult] as custodian for [name of child] under the [state] Uniform Transfers to Minors Act." Note that this language covers the possibility that the child might become an adult by the time a death benefit is paid. A substitute custodian should be named in case the primary custodian cannot serve.

Without a custodial nomination, it is possible that the insurance company will require appointment of a guardian of the minor's property prior to making payment of death proceeds. The only exception allows for payment of small amounts, usually $10,000, to either a trust company or an adult member of the minor's family (a no-nomination transfer).

To give an *existing* policy to a minor, the owner signs a change of ownership form naming the custodian as owner. In the case of a *new* policy, the custodian is designated as owner on the application. In either case, the ownership designation reads: "[name of adult], as custodian for [name of child] under the [state] Uniform Transfers to Minors Act." In contrast, the purchase of a policy using custodial funds is a reinvestment of funds. If the minor is the insured then the minor's estate should be named beneficiary. If someone else is the insured then the beneficiary must be the minor, the minor's estate, or a custodian, and the designation must be irrevocable so long as the custodianship remains in effect. In this situation the beneficiary designation might read: "[name of child], child of the insured, if living, otherwise to the estate of [name of child]; provided that the proceeds shall be paid to [name of adult] as custodian for [name of child] under the [state] Uniform Transfers to Minors Act if the proceeds become payable while such custodianship remains in effect; without the right to change while such custodianship remains in effect."

MONEY PURCHASE PENSION PLAN

Under the money purchase pension plan each employee/participant has an individual account into which the employer makes annual contributions pursuant to the plan's contribution formula. These employer contributions are required and the employer is subject to a minimum funding penalty if they are not made. The formula used to determine contribution amounts must be nondiscriminatory and typically sets employer contributions at a specific percentage of the employee's annual compensation. Only the first $265,000 (as indexed in 2015) of each employee's compensation can be taken into consideration. The maximum annual addition that can be contributed to a money purchase plan is the lesser of 100 percent of the participant's compensation, or $53,000 (as indexed in 2015). In determining the level of employer contributions, integration with Social Security is allowed.

The maximum amount an employer may deduct for money purchase plan contributions is 25 percent of compensation (i.e., generally payroll, but subject to the $265,000 per participant limit in 2015). Prior to 2002 this 25 percent limit provided money purchase pension plans with an advantage over profit sharing plans, since the deduction for profit sharing contributions was limited to 15 percent of payroll. Without this advantage, employers have increasingly chosen to establish the more flexible profit sharing plan, rather than a money purchase pension plan that requires annual employer contributions.

Unlike the defined benefit pension plan, under a money purchase pension plan the employee bears the investment risk of the plan (i.e., the employer is obligated only to make the initial contribution, after that *the risk of poor investment performance is borne by the participant*). The employee also bears the risk that the amounts accumulated at retirement might be insufficient to fund retirement needs. Upon retirement the participant's account balance can be paid in a lump sum, paid in installments for a number of years, or used to purchase an annuity providing an income for life (this is the origin of the term "money purchase"). Of all qualified plans the money purchase pension plan is generally considered the simplest to design, explain, install and administer.

See also, the discussions of Qualified Retirement Plans on page 519 and Life Insurance in Qualified Plans on pages 436-437.

NET UNREALIZED APPRECIATION

With certain exceptions, distributions from qualified retirement plans are subject to taxation as ordinary income. To avoid current taxation, it is common for an individual receiving a lump sum distribution from a qualified retirement plan to make a tax-free rollover to a traditional IRA. However, if the rollover includes *appreciated employer stock*, then the employee should consider taking distribution of the stock (i.e., not rolling it over into an IRA). By doing this, the stock's net unrealized appreciation (NUA) will qualify for long-term capital gains rates whenever the stock is sold by the employee, by the employee's spouse, or by the employee's heirs. NUA is the stock's fair market value in excess of basis. Basis is generally the value of the stock at the time that it was acquired by the plan. Subsequent appreciation of the stock in excess of NUA is taxed as either short-term or long-term capital gains, depending upon how long the stock is held after it is distributed from the plan. See capital gains, page 340.

To take advantage of this favorable tax treatment, the employee must receive the stock as part of a "lump sum distribution" from a qualified retirement plan (i.e., payment within one year of the entire account balance as a result of the employee's separation from service, attaining age 59½, disability, or death). The employee must also pay ordinary income taxes on the cost basis of the stock distributed (i.e., the value of the stock at the time that it was acquired by the plan). The decision for the employee comes down to this: Is it worth paying current ordinary income taxes on the stock's basis in return for obtaining long-term capital gains treatment for the stock's NUA at some point in the future?

The employee may also make a tax-free rollover to a traditional IRA of some, but not all, of the employer stock. (The NUA within the stock rolled over to the IRA would end up being taxed as ordinary income.) Likewise, when a distribution consists of both employer stock and other assets, these other assets may be rolled into an IRA to avoid current taxation. All rollovers must be made within 60 days of the distribution.

For example, assume an employee receives a lump-sum distribution from his 401(k) plan of $600,000 in employer stock with a cost basis of $125,000, pays ordinary income taxes on the $125,000, and sells the stock six years later for $850,000. Of this amount, the cost basis of $125,000 is not taxed (it was taxed upon distribution), NUA of $475,000 is taxed as long-term capital gains, and the after-distribution gain of $250,000 is taxed as either short-term or long-term capital gains – depending upon the holding period (long-term in this example).

If the stock with NUA remains unsold at death, the NUA is treated as income in respect of a decedent and it is not entitled to a step-up in basis (but it is entitled to capital gains treatment when sold by the heirs). See income in respect of a decedent, page 422, and stepped-up basis, page 561.

NIMCRUT

The term NIMCRUT stands for Net Income with Make-up Charitable Remainder UniTrust. As a form of charitable remainder unitrust (CRUT), the trust assets are valued annually creating a unitrust amount (variable annuity payment) made at least annually to one or more trust beneficiaries. Distributions consist of the *lesser of*: (1) a fixed percentage (not less than 5 percent) of the value of the trust assets (valued annually); or (2) the net income of the trust for the current year. Unlike the CRUT (see page 347), a make-up account is created in any year that income earned is less than the fixed percentage allowed. The make-up account is then paid out in any future year in which the income earned exceeds the fixed percentage payout for that specific year (i.e., the NIMCRUT provides for "make-up" distributions). No adjustment for the time value of money is allowed for these make-up distributions. *Pre-contribution* capital gains are generally not available for distribution. *Post-contribution* capital gains may be classified as income, provided this does not conflict with state law (see the discussion of the Prudent Investor Rule on page 513).

A NIMCRUT provides a great deal of flexibility for the donor who wishes to defer income for retirement. Trust income can be deferred by having the trustee make appropriate investment selections (e.g., a deferred annuity), or by donating to the trust low-income or non-income producing assets (e.g., growth stocks, closely held stock, or real estate). Unlike the CRUT, if trust income is not adequate, the trustee has no obligation to pay out the full unitrust amount and the donor may be positioned to receive larger make-up payments after retirement. Also, as with the CRUT, a donor may make multiple gifts to the same NIMCRUT. However, before making gifts to any NIMCRUT, it is essential that the donor fully understand that payments are contingent upon the trust earning income.

For the donor who desires greater flexibility, a FLIP unitrust might be considered. This technique begins with a NIMCRUT, or a NICRUT (similar to a NIMCRUT but without the makeup provisions), that is converted to a standard CRUT upon the occurrence of an approved triggering event. Approved triggering events cannot be controlled by the donor, unitrust beneficiary, trustee, or any other person. For example, the beneficiary's 65th birthday is an approved triggering event, but not the beneficiary's retirement, as that event is controlled by the beneficiary. Unfortunately, when a NIMCRUT flips to a standard CRUT, any outstanding make-up amounts are forfeited.

See also, Charitable Remainder Trust chart on page 55.

NONCITIZEN ESTATE PLANNING

For the purpose of estate and gift tax planning, it is helpful to recognize three categories of individuals: (1) United States citizens; (2) resident aliens (i.e., non-citizens who are resident in the United States); and (3) nonresident aliens (i.e., non-citizens who are resident in another country).

Resident aliens. The property of a resident alien is subject to United States estate and gift tax laws, no matter where it is located. For estate and gift tax purposes, residency means that the person is actually "domiciled" in the United States. Generally, a person acquires a domicile by living in a place, even for a brief period of time, with no definite present intention of leaving and living elsewhere. This is a rather subjective determination that is influenced by where the individual's time is spent, as well as the location of other family members, business interests, social activities, driver's license, and financial and tax relationships. It is important to recognize that although a person can have more than one "residence," they can have only one domicile (i.e., do not confuse the terms "residence" and "residency"). See the expanded discussion of domicile on page 385.

Although a resident alien is generally subject to the same estate and gift tax rules much the same as a United States citizen, the unlimited marital deduction is unavailable if the spouse is not a United States citizen (gifts to foreign spouses are limited to $147,000 in 2015, see page 516). Because of the unified gift and estate tax system, gifts made prior to becoming a resident may also be included in the resident alien's estate. However, resident aliens can take advantage of the full unified credit (page 18), annual exclusion gifts (page 46), split-gifts with spouses (page 46), and irrevocable life insurance trusts (page 50).

Nonresident aliens. Property located within the United States is subject to both gift and estate taxes (i.e., it has a "situs" within the United States and is therefore taxed). Only the first $60,000 of property is free of transfer taxes and the unlimited marital deduction is not available unless the spouse is a United States citizen (in 2015 gifts to foreign spouses are limited to $147,000, see page 516). Gifts of *tangible* property and *real estate* are subject to gift taxes (but gifts of *intangible* property are generally free of gift taxes). However, bank deposits and life insurance are specifically excluded from both gift and estate taxation (i.e., they are deemed not to have a "situs" within the United States). Thus, the proceeds of a life insurance policy on the life of a nonresident alien are not subject to estate taxes, even though the beneficiary is a resident or citizen of the United States.

A foreign death tax credit is available for estate taxes actually paid to a foreign country or United States possession in which the property is located (but there is no credit for foreign *gift* taxes). Foreign death and gift tax treaties can also offer relief from the double taxation often imposed upon both resident and nonresident aliens. However, such planning can be very complicated, and the advice of competent tax counsel should be sought.

NONQUALIFIED EXECUTIVE BENEFITS

Businesses are increasingly aware of the valuable role employee benefits play in the workplace. They have become essential in retaining and rewarding and motivating employees. Many employee benefits are offered to everyone in the organization. They consist of the more common or traditional types of benefits — such as 401(k) plans, health insurance, and paid vacation. While these benefits may include certain tax breaks and other advantages to employers, they are usually considered standard by employees in large organizations, and can be a determining factor in attracting employees to small businesses.

By contrast, Nonqualified Executive Benefits are designed primarily for highly compensated employees and key people. They can give key individuals an incentive to stay at an organization (''golden handcuffs'') and they can fill gaps where other benefits fall short. An example of the later may be a plan that supplements retirement income where caps on the employer's 401(k) plan may limit how much an executive can set aside to replace their income in retirement.

These plans fall under a category called Nonqualified Executive Benefits because they fall outside of the traditional qualified plans which must be offered to everyone and must comply with ERISA. These nonqualified plans can be discriminatory and offered to only a select group of employees. As such they can avoid certain aspects of ERISA such as participation requirements. However, the nature of the plan may pull them into certain other aspects of ERISA.

Employers should be careful as to how widely they offer these nonqualified benefits so as to be certain they remain limited, discriminatory plans. If they are offered too widely, or if they tend to fall into a repetitive pattern, they may be further pulled into full compliance under ERISA. As such, they should only be offered to a highly select group of executives, often called ''Top-Hat'' employees. Where possible an employer may want to offer customized terms to emphasize the selective nature of these plans. There are other times where the plan may need an outside administrator and some commonality may be incorporated to make it cost efficient to administer the plans. A good advisor can help balance these plans to keep them in a nonqualified category.

Nonqualified Plans fall under three broad categories:

- Executive Bonus
- Split Dollar, and
- Deferral Plans/Supplemental Executive Retirement Plans

Each is briefly discussed, below. When deciding between these plans there are contrasting considerations that need to be weighed. For example, certain arrangements afford the employer

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NONQUALIFIED EXECUTIVE BENEFITS (continued)

complete control at the expense of current deductibility. In other plans, the employer may receive a current tax deduction for funding the plan, but will generally retain less control over the plan. At times what an employer may value in a plan might conflict with what an employee might value as a benefit. Only after weighing and balancing these considerations is it possible to determine the appropriate plan for a particular employer and employee. Balancing the interests of both the employee and employer are critical in determining which plan will be mutually beneficial.

Executive Bonus plans are generally employer-paid life insurance where the policy is owned by the employee or a family member. These are often designed to offer death benefit protection, but are also often focused on additionally offering cash value with the potential for supplemental retirement income through policy withdrawals and loans.

Typically the employer will receive an immediate income tax deduction for the premium payments and the executive will pay taxes on the same amount. In some cases an employer may "gross-up" the executive's pay to cover the tax bill the executive might pay. This variation on Executive Bonus plans is often called a Double Bonus Plan. In other variations the employer might simply loan the tax amount to an Executive. However, they must be careful to not retain an interest or lien in the policy or they will jeopardize their income tax deduction.

With traditional Executive Bonus plans the policy is not controlled by the employer. Where an employer might wish some control a variation has developed that places an endorsement on the life insurance contract. The endorsement restricts the policyowner's rights in the contract until it is lifted by the employer. Generally the executive must meet certain requirements, such as years of service, at which point the restrictions are lifted. Although this is a limited control, it offers at least some element of control to the employer. This variation goes by several names such as Restricted Executive Bonus Arrangement (REBA) or Golden Handcuff Executive Bonus (GEBA).

Split Dollar plans are arrangements where the employer pays premiums for a life insurance policy and the policy's death benefit and cash values are split. The tax treatment of these plans is controlled by who owns the policy, the employer or employee.

Where the employer owns the contract, they generally own the cash value and have endorsed the death benefit over to the employee or a family member or trust. In these instances the employee, which retains an interest in the policy cannot deduct the premium payments. The Executive, who has no ownership in the policy, will recognize income taxation based on the death benefit they receive.

The amount of death benefit is net of the cash value owned by the employer. This is often called the risk portion of the policy. The amount of taxation is calculated based on this risk portion. A cost per each thousand dollars of death benefit is assessed as income to the employee each year. The amount is per thousand is generally controlled by Table 2001, established by the

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NONQUALIFIED EXECUTIVE BENEFITS (continued)

IRS in 2000 when it revamped guidelines for split dollar plans. Under certain circumstances a carrier's own term rates might be available as an alternative to Table 2001. For a more detailed discussion on Split Dollar see page 224.

There is different tax treatment where the employee (or an employee's trust or other third party) owns the policy. Under this other version of split dollar, the employer is treated as making a loan to the policy owner(s). Interest must be charge on the loan equal to the monthly federal rate, and relate to whether the loan is short term (under three years), mid-term (3-9 years) or long-term (longer than 9 years). The loan might also be a demand loan in which case the short term rate is charged. Most split dollar loans fall under these interest rate categories. However, if the rate is doesn't comply, it fall under the imputed income rules of Tax Code Section 7872 and certain additional interest might be recognized as early as the year of the loan.

Deferral and Supplemental Plans – these are two different varieties of plans where the employer controls the benefit the most directly and the employee remains a general creditor of the employer until they receive receipt of the benefit.

With a deferral plan, the employee defers current compensation or foregoes bonuses. These are held by the employer and usually some type of earnings are accrued for the benefit of the employees. The earnings can be based on the performance of the employer, one or more stock indices or mutual funds or even a fixed crediting rate. The benefit payout can then be made after a preselected (prior to the deferral) period of years, as retirement income or as survivor death benefits. With a supplemental plan (often called a SERP, or Supplemental Employee Retirement Plan) the employer proactively sets aside additional (supplemental) funds for a select group of employees. In keeping with the earlier discussion, this must be for a select group of upper level employees.

To avoid falling under ERISA these plans must remain "unfunded." Employers cannot offer any indication that funds or other business assets are specifically allocated to these nonqualified benefit plans. If this were to occur the deferral or supplemental plan may fall under ERISA as a funded plan subject to more stringent ERISA reporting and participation requirements. However, employers may informally fund these plans with either mutual funds matched to the executive elections or with life insurance. In many instances life insurance may offer a tax advantage because funds can grow tax deferred. With variable life insurance policies an employer might be able to closely match changes executives make in their deferral elections. Whether life insurance or mutual funds are used can be a subjective choice and will often turn on the preferences of a third party administrator (TPA) who may be involved in helping a business handle these plans from a reporting, balance sheet and tax perspective. Because these plans are "unfunded" and the employee remains a general creditor of the employer, some executives use a Rabbi Trust to help offer some protection from creditors. These are discussed at page 521.

NONQUALIFIED STOCK OPTIONS

Nonqualified stock options (NQSOs), also referred to as "nonstatutory stock options," are rights to purchase a certain number of shares of stock at a fixed exercise price within a specified period of time. With NQSOs a corporation is able to provide selected employees with the opportunity to share in the future growth of the company, without having to make any current cash outlays for salary or bonuses. Because there are few regulatory restrictions on how they may be designed, NQSOs offer a great deal of flexibility in meeting specific corporate objectives.

The option's exercise price is often referred to as the grant price or strike price. It may be set at the full fair market value (FMV) of the stock as of the date of the grant, at a price below FMV (at a "discount"), or at a price above FMV (at a "premium"). Options may be exercised after the passage of a set period, upon the occurrence of a certain event, and may even be immediately exercisable, although this is not usual. They can also be subject to vesting rules (e.g., after 3 years of continuous employment).

At the time they are granted NQSOs are generally not taxed to the employee, provided they do not have a "readily ascertainable fair market value." In contrast to options for stock actively traded on an established market, an option to acquire closely held stock has no readily ascertainable fair market value. (Note that it is the option itself that must be tradable, not the underlying stock.) When the option is exercised the difference between the exercise price and the market value, referred to as the bargain element, is taxed to the employee as ordinary income. At the time of exercise the employer is entitled to a corresponding compensation deduction.

NQSOs are referred to as "nonqualified" stock options because they do not meet the requirements of the Code to be qualified as "incentive" stock options (ISOs). Although ISOs offer income tax advantages that are not available to NQSOs, the Code imposes limitations and restrictions upon ISOs that are not applicable to NQSOs. For example, ISO gains may be taxed at favorable capital gains rates, but ISOs are not transferable during lifetime.

In contrast to ISOs, if permitted by the underlying stock option agreement or plan, NQSOs are transferable during the employee's lifetime. Provided the option is vested, its transfer to a child or other heir is treated as a completed gift (see chart, page 47). However, the donor-employee remains liable for any income taxes when the option is subsequently exercised by the donee-child (i.e., the income tax consequences cannot be transferred). This tax treatment is similar to that imposed upon the trust income of a Intentionally Defective Trust (see chart, page 67).

See also, the discussion of Incentive Stock Options on page 420.

ORAL TRUSTS

Ordinarily, considerable care goes into drafting a trust document. The provisions of the trust are carefully considered to obtain the desired fiduciary standards and the desired tax results. But, in practice, the use of oral trusts is not uncommon. For example, it is not unusual at the end of the year for advisors to transfer property under an oral trust to take advantage of annual gift tax exclusions or to otherwise facilitate year-end planning. So, can you create an oral trust?

In most jurisdictions, establishing a trust does not require a written document. However, the difficulties with an oral trust are considerable. As between grantor and trustee, the existence of a trust might be clear, but for the trust to be respected by all other parties (e.g., the IRS or the courts), some evidence is necessary. For starters, the terms of the trust must be established. Without a written trust agreement, the conduct of the parties and other evidence must be examined to determine if a trust exists and what the terms of that trust are. Often, the dispute over trust terms will happen at the most inopportune time – after the death or disability of the purported grantor. Moreover, trusts are often used to move property out of the grantor's estate for estate planning purposes. Imagine the difficulty, without documentary evidence, of convincing the IRS that the transfer was irrevocable, immediate, and that the grantor retained no interests, rights, or powers over the property that would cause the property to be included in the transferor's estate.

In addition to practical considerations, local law must be considered when looking to the enforceability of a purported oral trust. This becomes particularly problematic when the property at issue is real property. Most (but not all) states specifically require a writing to create a trust of real property. This requirement dates back to the Statute of Frauds incorporated into English law in 1677. A number of states specifically prohibit oral trusts for other types of property as well.

In short, while it might be slightly over-stated, the old adage that "an oral trust is not worth the paper it's printed on" is solid advice. While the oral trust is sometimes discussed as a year-end or temporary solution – it is not usually a solution that is prudent. It is far better to engage a qualified attorney and create a written trust that complies with local law and protects the desired property and tax results. Careful planning at the time of the transfer in trust can create considerable problems down the road.

PARTNERSHIPS

Family Limited Partnership

A chart describing the family limited partnership (FLP) is on page 170. The following advantages, disadvantages, and requirements will help in better understanding this important planning technique.

The principal *advantages* of the FLP include:

1. **Retention of control** by the general partner, who has property which he is willing to transfer to family members but is reluctant to lose control over the property. A general partner operating under a well-drafted partnership agreement can maintain indirect control without adverse income and estate tax consequences.

2. **Shifting of income** within certain family partnership limits. The general partner often has the power to retain current profits for investment and reasonable business needs.

3. **Protection of partnership assets** from the creditors of limited partners by restricting the limited partners ability to dispose of their limited partnership interests. Because the general partner has the ability to retain profits, the flow through nature of partnership income taxation gives him the ability to create a tax liability without making cash distributions for tax payments (i.e., an "ugly" asset).

4. **Reduction of value** through minority discounts and lack of marketability. The typical limited partnership gift represents a minority interest. Lack of marketability can be established by prohibitions against terminating the partnership without the concurrence of all partners (this prohibition is usually limited to 40 years or less). Valuation discounts can range from 30 to 70 percent.

5. **Facilitating gifts** of assets which otherwise are not easily divisible (e.g., the family farm). Often the ultimate goal is for the parent to eventually own only modest partnership interests, with the bulk of the FLP being held by other family members.

Some *disadvantages* of the FLP include:

1. The traditional partnership freeze is subject to the impact of the Chapter 14 valuation rules (see pages 402-403). However, most of the techniques used to reduce the effect of, or to avoid, these rules with respect to recapitalizations will also work with partnerships.

2. Much of the ability to reduce taxes by shifting income from parent to younger children has been curtailed by the "kiddie tax" (see discussion on page 580).

(continued on next page)

PARTNERSHIPS (continued)

3. There are additional expenses associated with establishing and accounting for an FLP (e.g., filing and annual fees, an information tax return must be filed).
4. Gifts do not receive a step-up in income tax basis.
5. Retained partnership interests continue to appreciate in the parent's estate until they are transferred during lifetime or at death.

The principal *requirements* for an FLP are:

1. Capital must be a material income-producing factor requiring management. A personal service business where income consists primarily of fees or commissions would not qualify for operation as a family partnership (lawyer, doctor, photographer, plumber, etc.).
2. If the partnership has been created by gift, the donor (parent) must be given a reasonable salary for services rendered to the partnership before profits can be allocated among the partners (the concept of "gift" also includes intra-family sales).
3. Profits of the partnership must be allocated, or divided, in proportion to each partner's capital investment.
4. All partners must actually own a "capital interest" (i.e., an interest in partnership assets which is distributable to the partner upon his withdrawal from the partnership or upon partnership liquidation).
5. In order to avoid inclusion under Code section 2036 (i.e., prohibition against retained life estates) of the underlying partnership assets (rather than the partnership itself) a donor or decedent should adhere to all partnership formalities and *should not*: (1) put virtually everything they own in the partnership; (2) retain complete control over the income of the partnership; and (3) use the partnership to pay personal expenses (see also, page 406).

(continued on next page)

PARTNERSHIPS (continued)

Partnership Used As Alternative To Irrevocable Life Insurance Trust

Partnerships are increasingly being used as a substitute for the irrevocable life insurance trust. When contrasted to the irrevocable life insurance trust the primary advantages of a partnership are the *control* that a general partner can exercise over the partnership, which is not available with a trust since the grantor cannot be a trustee, and the *flexibility* a partnership offers to adjust to changing circumstances, which is not available with the irrevocable life insurance trust. Implementation of the technique involves creation of either a general or limited partnership of which the insured is the managing or general partner. Limited partnership interests are obtained by family members either by having the insured make cash gifts to them, after which the funds are contributed to the partnership in return for partnership interests, or by having the insured contribute cash to the partnership in return for partnership interests which are then given to family members. Assuming the insured holds no incidents of ownership, and the death proceeds are paid to the partnership, only his proportionate partnership share, including the insurance proceeds, will be in his estate.

Partnership Created To Avoid Transfer For Value Problem

Insurance death benefits paid to a C corporation to fund a stock redemption agreement may be subject to the corporate alternative minimum tax (see pages 363-365). Although the AMT can be avoided by converting to a cross purchase agreement, transferring existing corporate owned policies to co-stockholders of the insured can run afoul of the transfer for value rules, meaning that the death benefits would be subject to ordinary income taxes (see pages 573-574). Transfers to a partnership of which the insured is a partner are exempt from the transfer for value rules. In a private letter ruling, the IRS has approved the creation of a partnership for the purpose of receiving corporate-owned policies. Although a partnership must be for a valid business purpose, and not just for avoiding taxes, this ruling appears to approve a partnership whose sole purpose is to "engage in the purchase and acquisition of life insurance policies on the lives of the partners." However, use of this technique might cause the proceeds received by the partnership to be taxed in the insured's estate, since the proceeds are not being retained by the partnership, but rather distributed to the surviving partners to fund a cross purchase agreement (i.e., as a partner the insured possesses an incident of ownership in the policy on his own life and there may be no double taxation issue since the value of the proceeds are not included in valuing the insured's partnership interest). It is probably advisable to avoid using such a "sole purpose" partnership until this estate taxation issue is resolved.

PENALTIES – ESTATE AND GIFT TAXES

Failure to file return. A 5 percent penalty if the failure is for not more than 1 month, with an additional 5 percent for each additional month, not to exceed a total of 25 percent; unless it is shown that the failure was due to reasonable cause and not due to willful neglect. If the failure to file is fraudulent then the monthly penalty is increased from 5 percent to 15 percent, and the total penalty from 25 percent to 75 percent. *Section 6651*.

Failure to pay tax. A 0.5 percent penalty if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month, not to exceed a total of 25 percent; unless it is shown that the failure was due to reasonable cause and not due to willful neglect. *Section 6651*.

Fraud penalty. Penalty is 75 percent of the underpayment attributable to fraud. If the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment will be treated as such. The taxpayer must establish the part not attributable to fraud. *Section 6663*.

Accuracy related penalty. A 20 percent penalty is imposed on any underpayment attributable to negligence or a *substantial* valuation understatement. A substantial valuation understatement exists if the value of property on the return is 65 percent or less of the amount determined to be correct (penalty is 40 percent if property on return is 40 percent or less of correct amount). No penalty for a substantial valuation understatement is imposed if the underpayment is no more than $5,000. Also, no penalty is imposed if the taxpayer acts with reasonable cause and good faith. *Sections 6662 and 6664*.

Statute of limitations on assessment. Generally, 3 years after return filed. If the taxpayer omits items that exceed 25 percent of total amounts stated on return, statute of limitations is 6 years after date of return. There is no statute of limitations if no return is filed, or if return was false or fraudulent and filed with intent to evade tax. *Section 6501*.

False statement as crime. Any person who under the penalties of perjury willfully makes and subscribes a return, statement, or other document, and who does not believe it to be true and correct, is guilty of a felony, and will be fined not more than $100,000 or imprisoned not more than 3 years, or both, together with the costs of prosecution. *Section 7206*.

Removal or concealment as crime. Any person who removes or conceals any goods with intent to evade or defeat the assessment or collection of taxes is guilty of a felony, and will be fined not more than $100,000 or imprisoned not more than 3 years, or both, together with the costs of prosecution. *Section 7206*.

Statute of limitations on criminal prosecutions. If the taxpayer willfully attempts to evade any payment or willfully fails to make a return or pay a tax, the statute of limitations is 6 years. *Section 6531*.

PENSION BENEFIT GUARANTY CORPORATION (PBGC)

The PBGC is a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to protect defined benefit pension plans (defined contribution plans are not covered). Plans sponsored by churches, governmental bodies, and small professional employers with fewer than 26 employees are generally not covered by the PBGC. The PBGC guarantees "basic benefits" earned before a plan has been terminated, which include: (1) pension benefits at normal retirement age; (2) most early retirement benefits; (3) annuity benefits for survivors of plan participants; and (4) disability benefits for disabilities that occurred before the plan ended. Benefits are not adjusted for inflation (i.e., there are no cost-of-living increases). Health care, vacation pay, and severance pay are not guaranteed. (But recipients age 55 or over who are covered by qualified health insurance may be eligible for the Health Coverage Tax Credit administered by the IRS.)

Although most people receive the full benefit they earn before the plan ends, there is a maximum benefit guaranteed by the PGBC according to the year the plan is terminated. For example, with pension plans ending in 2015, the maximum guaranteed amount is $5011.33 per month ($60,136 per year) for workers who retire at age 65. The maximum guaranteed amount is lower if the participant receives payments before age 65, or if the pension includes benefits for a survivor or other beneficiary (e.g., a joint and survivor annuity).

PER STIRPES – PER CAPITA

These terms are used in making beneficiary designations in life insurance policies, wills, and trusts.

The term **per stirpes** is used when it is desired that the share of a deceased beneficiary go to the beneficiary's children (in Latin it means "by the trunk," "by right of representation," or "by roots or stocks"). For example, assume John Smith desires to name his wife primary beneficiary of his life insurance policy with his children as contingent beneficiaries. However, should one of his children predecease him, John wants the children of that child (i.e., his grandchildren) to share equally their deceased parent's share. The following beneficiary wording might be used: "Sally Smith, wife of the insured, if she survives the insured, otherwise in equal shares to the surviving children of the insured, and to the surviving children of any deceased children of the insured, per stirpes." If Sally died before John and upon his subsequent death John had two children who were alive (A and B) and one child who had previously died leaving two children (deceased child C who left John's grandchildren D and E), then A and B would each take one-third of the proceeds and D and E would each take one-sixth of the proceeds (i.e., they would share their deceased parents' one-third). In some jurisdictions the term "by representation" is used in lieu of "per stirpes."

The term **per capita** is used when it is desired that the children of a deceased beneficiary share equally with the surviving members of the original group of beneficiaries (in Latin it means "by the head," "according to the number of individuals," or "share and share alike"). Again, assume that John Smith desires to name his wife primary beneficiary of his life insurance policy with his children as contingent beneficiaries. However, should one of his children predecease him, John wants the children of that child (i.e., his grandchildren) to share equally with all other beneficiaries. The following beneficiary wording might be used: "Sally Smith, wife of the insured, if she survives the insured, otherwise in equal shares to the surviving children of the insured, and to the surviving children of any deceased children of the insured, per capita." Again, if Sally died before John and upon his subsequent death John had two children who were alive (A and B) and one child who had previously died leaving two children (deceased child C who left John's grandchildren D and E), then A, B, D, and E would each take one-fourth of the proceeds (i.e., all beneficiaries would share equally).

For an expended discussion of beneficiary designations involving minors, see page 483.

PERSONAL HOLDING COMPANY

A personal holding company exists when more than 50 percent of a corporation's outstanding stock is owned by 5 or fewer individuals, directly or indirectly, and 60 percent of the corporation's adjusted ordinary gross income is personal holding company income. Personal holding company income is essentially passive income such as dividends, rents, and royalties. If this income is not distributed during the year it will be subject to a 20 percent penalty tax in 2015 (as increased from 15 percent by the American Taxpayer Relief Act of 2012).

Because of the limited marketability of personal holding company stock, courts have often allowed substantial valuation discounts (i.e., the stock of the personal holding company is held to be worth less than the value of its underlying assets). Because of this, under some circumstances personal holding companies can function as a particularly effective means of transferring future appreciation to other family members.

For example, an individual with a large estate containing a portfolio of stock that is expected to appreciate substantially would form a corporation with both voting and nonvoting common stock. His portfolio of stock is transferred to the personal holding company in return for the voting and nonvoting common stock. Thereafter, the nonvoting common is transferred by gift, or by sale, to other family members, and all future appreciation of this stock is shifted outside the stockholder's estate. By retaining ownership of the voting common the stockholder maintains control of the personal holding company (and of the investment decisions).

In addition to the penalty tax on undistributed income, a personal holding company can result in double taxation if appreciated assets are sold and the proceeds distributed to stockholders. Also, it is important to avoid running afoul of the special valuation provisions of Chapter 14 (see discussion on pages 402-403).

The penalty tax can be avoided with regard to a personal service contract by having the corporation reserve to itself the right to designate the professional who is to render services rather than giving the client the right to make the choice. In that case the income from such a personal service contract is not treated as personal holding company income.

PET ESTATE PLANNING

The law treats a pet as tangible personal property. The simplest way of providing for a pet after the owner's death is to identify a relative or close friend to whom a testamentary transfer of both the pet and sufficient funds to care for the pet can be made. While this method may be the least expensive, it is subject to will challenges by disgruntled relatives, does not become effective until the will is probated, and is not legally enforceable.

Trusts. The vast majority of states have passed laws that enable pet owners to set up trusts providing funds for the care of pets after the owner has died. (See, *e.g*., Texas Property Code § 112.037) While these statutes vary widely, they commonly recognize pet trusts as valid and enforceable and provide for termination of the trust upon the death of the pet (see www.professorbeyer.com/Articles/Animal_Statutes.html). Under most of these statutes, the courts are authorized to reduce the amount transferred in trust if it is determined that the trust property substantially exceeds the amount needed for pet care (e.g., Leona Helmsley's bequest of $12 million to her aptly named dog Trouble). Both inter vivos and testamentary pet trusts are used. An inter vivos trust offers the advantage that it becomes effective immediately and the trustee is empowered to use trust assets to care for a pet immediately upon the owner's disability or death. However, inter vivos trusts typically entail additional start-up costs and administration fees. Although pet trusts often have a separate trustee and caretaker, many pet trusts simply use a single caretaker-trustee.

Caretaker organizations. There are numerous organizations that have established formal programs for the care of pets after the death of the owner. Typically these charities and perpetual care programs involve payments or donations to the organization prior to or after the owner's death (see www.professorbeyer.com/Articles/Animals_More_Information.html).

Power of attorney. Language may be included in a pet owner's durable power of attorney that gives the owner's agent express authority to care for the pet (see page 386). Such authority should include permission to take possession of the pet and to further use the funds supplied to provide for the health, care, and welfare of the pet.

Living will. This document provides direction to the veterinarian and other pet care providers regarding the owner's feeling about end-of-life treatment and euthanasia.

Pet card. This is a card carried in the owner's wallet or purse for the purpose of providing information about the pet. The information provided includes the pet's name, location, breed, sex, and veterinarian. Availability of the card helps assure that the animal survives to the time when the owner's plans for the pet's care can take effect.

PHANTOM STOCK PLAN

Phantom stock plans are a form of nonqualified deferred compensation made available to select employees. They are also referred to as "shadow stock plans" or "as if" deferred compensation (i.e., the amount deferred is treated as if invested in a designated stock, most often that of the employer).

The advantage to the employee is that his efforts and loyalty are rewarded by having an economic interest or stake in the business similar to that of the owners. The advantage to the owners of a small and closely held family business is that they are able to retain a valued employee without diminishing their percentage of ownership. Phantom stock plans are used in both regular C corporations and S corporations, limited liability companies, partnerships, and sole proprietorships.

To implement a phantom stock plan, a bookkeeping account in the name of the employee is established. This account is then credited with hypothetical shares of stock (when used with a noncorporate employer, the business equity credited to the employee is referred to as a "participation unit"). Periodically, the account can be credited with additional stock, as well as with dividends and stock splits. The deferral period is usually set at a specific number of years or upon the employee's retirement. At the end of the deferral period, the employee is entitled to receive cash payments equal to the excess of the market value of the stock on that date over its value on the date awarded. If appropriate, a vesting schedule can be used that provides for nonforfeitable appreciation rights prior to the end of the deferral period.

The terms "stock appreciation right" and SAR have been used to describe a benefit under which the employee receives only the appreciation of the stock, but not the stock value itself. For example, assume that ten shares of stock are awarded to an employee, with a current value of $150 each. If, at the end of the deferral period, the stock has increased in value to $275 per share, the employee is entitled to a payment of $1,250 ($275 - $150 = $125 appreciation per share; $125 x 10 shares = $1,250). Alternatively, in addition to any appreciation, the plan could provide for the employee to receive the underlying value of the stock. Assuming such a design, the employee would be entitled to a payment of $2,750 ($1,500 initial stock value plus $1,250 appreciation).

As with other nonqualified deferred compensation plans, the employer's obligation to the employee is unsecured. Income is not recognized by the employee until the benefits are actually paid or made available. The employer then deducts the payment made to the employee (assuming compensation is reasonable, see page 581). Phantom stock plans are often informally funded with cash value life insurance. Life insurance also allows the employer to provide a pre-retirement death benefit payable to the employee's family (see chart entitled Deferred Compensation on page 241, and footnotes 6 and 7 on page 243).

PLANNED GIVING

The term "planned giving" can be defined in terms of the **sources of funds** which donors use to make charitable gifts. In contrast to the annual gifts made from the donor's *disposable income* in support of the operational needs of a charitable or religious organization, the concept of planned giving involves gifts of the donor's *accumulated assets* to ensure the organization's long-term financial viability. The process often requires that donors make decisions regarding the distribution of significant portions of their estates. In recognizing that planned gifts must be coordinated with the donor's overall financial and estate plans, one definition simply describes planned giving as involving "any charitable gift that requires assistance by a qualified professional to complete." The terms "deferred giving" and "charitable gift planning" are also used.

Planned giving can also be defined in terms of the **techniques and products** used when making charitable gifts. In addition to providing for a substantial charitable gift, the donor and his family also often enjoy both income and estate tax benefits and an ongoing income. These techniques and products include:

1. **Wills** that transfer assets by *outright* bequests of named assets (e.g., cash or real estate), *residuary* bequests of property remaining after payment of debts, estate costs, devises, bequests, and legacies, and *contingent* bequests (e.g., "I direct payment of $100,000 to XYZ Charity provided my spouse dies before me").

2. **Retirement plan assets** transferred at death from both IRAs and qualified retirement plans – see pages 310, 348-349, and 519.

3. **Charitable gift** annuities providing income as a general obligation of the charity and **pooled income funds** providing income from co-mingled investments – see page 347.

4. Charitable trusts, including:

   a. **Charitable remainder annuity trust** paying a fixed amount annually to the donor or other beneficiary – see pages 54 and 347.

   b. **Charitable remainder unitrust** paying a fixed percentage of the trust's value, as determined yearly. Variations of the unitrust include net income with makeup unitrusts (NIMCRUT), net income unitrusts (NICRUT), FLIP unitrusts, and charitable lead trusts (CLT) – see pages 54, 347 and 486.

5. **Life insurance** by transferring ownership directly or by irrevocably designating the charity as owner and beneficiary – see page 346.

6. **Private foundations** and **donor-advised funds** allowing for limited donor influence over fund disbursements – see page 508.

PORTABILITY

Historically, each individual had the right to leave to the next generation a specific amount of property free of the federal estate tax. This could be done during lifetime by gift, or upon death, but the right could not be passed to a surviving spouse (i.e., you either used it during lifetime or upon death, or you lost it). It required prior planning to take advantage of the exemption.

The 2010 Tax Relief Act introduced the concept of portability by allowing any unused exemption to be passed to a surviving spouse. There was no longer a need to re-title assets and establish complex wills and trusts (e.g., QTIP, credit shelter, by-pass, or family trusts) solely for this purpose. The unused exemption is called the "Deceased Spousal Unused Exclusion Amount," or DSUEA. In order to take advantage of this portability, the executor of the estate of the deceased spouse need only file an estate tax return and make a DSUEA election. Under The 2010 Tax Relief Act, the exemption was increased to $5,000,000 per person and indexed for inflation beginning in 2012. The American Taxpayer Relief Act of 2012 made permanent both portability and the $5,000,000 exemption with indexing (as indexed, the exemption was increased to $5,430,000 in 2015).

Assuming none of the $5,430,000 was used by a decedent during life, adding the $5,430,000 DSUEA to the surviving spouse's "basic exclusion amount" of $5,430,000 produces an "applicable exclusion amount" of $10,860,000 in 2015. This is the amount that can be passed during lifetime or at death by the surviving spouse free of federal gift or estate taxes. The DSUEA is limited to that of the *last* deceased spouse. It is not clear that the DSUEA would be indexed for inflation (but it would be indexed up to the deceased spouse's date of death). It is also not yet clear whether DSUEA can be applied to gifts made made by the surviving spouse in a year other than the year of election.

Despite the advent of portability, there remain many non-tax reasons to use trust wills in estate plans. Surviving families require asset management, parents require assurance that assets will pass to their children and not to subsequent spouses, professionals require asset protection from civil suits, blended and nontraditional families have special needs, business interests must be continued, and incapacity planning often can best be accomplished with trusts.

It may be ill-advised to rely solely on the portability of the federal estate tax exemption to plan an estate, as many states have their own *state death taxes* and virtually all states are continually seeking new sources of income in a financially challenging economy. Portability does not apply to generation-skipping transfers (i.e., a surviving spouse cannot receive the deceased spouse's unused GST exemption).

However, taken together, portability and indexing of the exemption have begun a major transformation in the estate planning community.

POST MORTEM PLANNING

Post mortem (after death) planning is not limited to merely "picking up the pieces" for the families of decedents who have failed to plan in advance. In fact, rather than being a substitute for good planning, post mortem planning is best used as a means of effectively implementing plans that had been set in motion during the decedent's life, or of adapting to changing circumstances prior to or after the decedent's death. No matter how well an estate is planned, changing family and business circumstances, not to mention estate tax laws that are ever mutating, make it essential to build flexibility into every estate plan (see page 5). Such flexibility anticipates the use of both tax and nontax post mortem planning options and elections. The following are examples of some of these techniques:

Disclaimers. The use of disclaimers in estate planning can often result in obtaining greater flexibility by providing the opportunity for post mortem decisions, when more facts are likely to be available regarding assets, taxes, and beneficiaries. Disclaimers can be used with respect to gifts, wills, or even life insurance proceeds. The disclaimant has no authority to direct the distribution of the property, and it passes as though the disclaimant had predeceased the decedent. See Disclaimer on page 380.

Section 6166 election. Estate taxes attributable to an interest in a closely held business may be paid in installments, provided certain conditions are met. See Deferral of Estate Tax on page 373.

QTIP election. Not only gives the executor the power to determine how much, if any, of the estate will be taxed at the first death, but also provides great flexibility for post death planning based upon changing circumstances. See the QTIP Trust chart on page 35.

Alternate valuation date. Electing to value the gross estate 6 months after death can lower estate taxes. See Fair Market Value on page 407.

Special use valuation. Lower valuations can help to minimize federal estate taxes, provided the estate qualifies and the required restrictions are acceptable to the heirs. See Reduced Valuation on pages 525-526.

Donation of conservation easements. Allowing for a donation to be made after the decedent's death, but before the estate tax return is filed, can significantly reduce estate taxes, while allowing a family to retain their lands. See Qualified Conservation Easement on page 514.

Section 303 redemptions. These after-death sales of partial stock interests to a corporation receive tax-favored treatment as capital transactions, rather than as dividends. See the Partial Stock Redemption chart on page 155.

POWER OF APPOINTMENT

A power of appointment is the delegation of authority from one individual (the donor) to another individual (the donee) to direct the transfer, use, benefit, or enjoyment of property, both real and personal. A power exercisable in favor of the power-holder, his estate, his creditors, or the creditors of his estate is a *general* power of appointment. Any other power of appointment is a *special* power of appointment.

Whether a power of appointment is general or special is important, since a general power of appointment will cause the value of any assets subject to the power to be included in the power-holder's estate (even if the power is not exercised), whereas the value of any assets subject to a special power of appointment is generally excluded for estate tax purposes. The existence, release, or lapse of a general power of appointment all have the potential of causing the property subject to such power to be included in the estate of the power-holder.

With the exemption trust will, as shown in the chart on page 25, property placed in the marital trust ("A" trust) will qualify for the marital deduction only if the surviving spouse has a general power of appointment over the property (an exception to this statement would be a trust that qualified as a QTIP trust). This assures that even though the property was not taxed at the first death, it will eventually be subject to estate taxes upon the subsequent death of the surviving spouse.

If the power to consume, invade, or appropriate property from a trust is limited to *ascertainable standards* (e.g., for "health, education, maintenance, or support," but not for "comfort, welfare, or happiness"), it will not be considered to be a general power of appointment. Again referring to the chart on page 25, a surviving spouse can be given the right to invade the family or nonmarital trust ("B" trust) without causing the trust property to be included in her estate (except to the limit of the standard), provided the power is limited to such ascertainable standards, and therefore not treated as a general power of appointment.

Even though it might be considered a general power of appointment, a noncumulative power of appointment that does not exceed the greater of $5,000 or 5 percent of the value of the assets subject to the power (such as a trust) will not cause the lapse of such a power to be treated as a gift or included in the power-holder's estate. However, such a power held at death would be included in the power-holder's estate. See also the expanded discussion of the Marital Deduction on page 473.

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PREMIUM FINANCING

The term "premium financing" describes a method of purchasing large premium life insurance contracts using money borrowed from a commercial bank or lender. (In contrast, see the discussion of Minimum Deposit Insurance on page 481.)

Low market interest rates usually bring increased attention to premium financing as a means of funding the termination of split-dollar plans (see Split-Dollar Rollout, page 558). Premium financing is also used to fund company-owned life insurance (see discussion on page 357) and trust-owned life insurance. With an irrevocable life insurance trust, the loan is entered into between the trustee and the lender, and interest payments are often made from gifts to the trust by the trust grantor or others (see Life Insurance Trust chart, page 51).

Where a policy is purchased using premium financing the loan is typically collateralized by the underlying life insurance policy, but additional collateral may be required. It is important to recognize that there are no tax advantages to premium financing, since the interest paid will *not* be tax deductible (i.e., 4 out of 7 years' premiums will not have been paid from unborrowed funds, see page 481).

The rate of interest is often based upon commercial loan rates using the one-year LIBOR (London Interbank Offered Rate), plus a spread and loan origination free totaling perhaps 1.5 to 2.0 percent. For example, the November, 2013, one-year LIBOR was 0.60 percent, meaning that the effective typical interest rate for premium financing would be approximately 2.6 percent. Although the spread is typically guaranteed for the loan's duration, because the underlying LIBOR rate is subject to annual adjustments the loan interest rate can increase substantially (e.g., in November, 2006, the one-year LIBOR was 5.24 percent, or 4.64 percent *higher*). Also, unlike the loan provisions provided in most life insurance contracts, if the underlying insurance contract requires ongoing premium payments, commercial lenders are unlikely to guarantee rates to be charged on future loans. However, lenders may not provide assurance that future loans will be made.

In order for premium financing to work over a period of years, it is essential that the rate of return on policy values (cash values and death benefit that are intended to repay the loan) exceed the interest rate paid on the loan. With interest rates at or near historic lows, there is often a differential between these loan rates and higher current (or projected, but not guaranteed) policy earnings rates. This arbitrage opportunity may at first appear attractive, but there are many variables that can negatively impact the results obtained. They should be carefully evaluated.

PRIVATE ANNUITY

The private annuity has been most effectively used in family situations where it is desired to make a transfer of a business interest, or other asset, from one generation to the next free of estate taxes (see chart, page 43). Under a typical private annuity transaction, a parent will sell part or all of the business interest, or other asset, to his child or children. In return, the children would promise to pay the parent an income for life (called a "straight life" annuity). While the annuity obligation cannot be secured, it does represent a contractual obligation that is legally enforceable. Since payments terminate at the parent's death, the annuity has generally been considered to have no value and to escape taxation in the parent's estate.

The amount of the annual payment is determined by use of annuity valuation factors. The entire amount of the gain or loss must be recognized at the time of the transaction. Annuity payments are made up of interest income and a nontaxable recovery of basis. If it is desired to provide an ongoing income to *both* surviving parents, a reduced income can be paid for as long as either parent is alive (called a "joint and survivor" annuity). Although the value of the survivorship benefit is includable in the estate of the first parent to die, it should escape taxation because of the unlimited marital deduction. At the time the annuity is established, the child receives a "temporary basis" equal to the value used in calculating the annuity. After the parent's death, this temporary basis is adjusted to reflect the amount actually paid.

It would be best to avoid stipulating lower annual payments than those calculated under the annuity tables. Such annuity payments result in a gift from the parent to the child (i.e., the child is not paying full value from his separate funds). If there is a gift element, then its value is the difference between the fair market value of the asset and the present value of the annuity payments.

Furthermore, if the child does not pay full value, the property transferred in exchange for the private annuity could be included in the parent's estate as a gift with a retained life estate. The courts have also found a gift with retained life estate (resulting in the full value being included in the grantor's estate) where a grantor transferred assets to her grantor trust in exchange for a private annuity for less than adequate consideration.

PRIVATE FOUNDATION

A private foundation is a not-for-profit organization established by an individual charitable donor that operates as either a trust or a corporation. (It is referred to by the IRS as a "private non-operating foundation.") The foundation is controlled by the foundation's board or trustees, who may be selected by the founder. Private foundations are particularly suited to those individuals who wish to make substantial donations while providing a lasting legacy in the family name. Unlike outright gifts to public charities, the founder and family are able to maintain control over assets given to the foundation and retain the flexibility to redirect charitable gifts with changing community needs. Active involvement of the founder's children and other family members as board members has the ancillary benefit of teaching others how to share the family wealth consistent with the founder's values and vision.

To assure that private foundations adequately serve a public purpose, there are very strict rules and regulations governing their operation. In particular, a prohibition against "self-dealing" prevents any transactions, with certain exceptions, between the foundation and "disqualified persons." Such disqualified persons include the founder, the founder's spouse, and lineal descendants, as well as the foundation managers and others involved in business relationships with a substantial contributor to the foundation. Compliance with these rules is essential and penalties for self-dealing are substantial. One exception to these rules allows disqualified persons to be paid by the foundation for reasonable and necessary work performed for the foundation, provided the compensation is reasonable.

Although the earnings on investments held by private foundations are not subject to income taxes, they are subject to an excise tax of 2 percent on investment income. Income on investments must be distributed to qualified charities each year. Regardless of income, approximately 5 percent of its "net investment assets" are required to be distributed within 12 months of the close of the fiscal year. Specific steps must be taken to verify the tax-exempt status of grant recipients. Added to these requirements are annual information tax returns, corporate filings, documentation of gifts received, and requirements for public inspection and disclosure.

The maximum amount a donor may deduct in one year for gifts to a private foundation is 30 percent of his contribution base, generally equal to adjusted gross income. This is reduced to 20 percent for appreciated capital gain property (see footnote 4, page 57). Private foundations cannot receive gifts of interests in a closely held or family-owned business stock under the rules governing "excess business holdings."

PRIVATE PENSION

The term "private pension" is occasionally used in describing life insurance products that offer investment elements in addition to death benefits. For the following reasons it is recommended that agents and their companies avoid using the term in the marketing and sales of individual life insurance policies.

It is suggested that to the average consumer the term "pension" implies a plan that is sponsored by an employer and qualified under the tax code as to the deductibility of employer contributions, without current taxation to the employee. *Webster's New Dictionary* defines a "pension" as "a stated allowance to a person for past services; an allowance to one who has retired or has been disabled or reached old age, or has been widowed, orphaned, etc." The term "private pension plan" can be found in section 2(c) of the Findings And Declaration Section of ERISA, which states: "It is hereby further declared to be the policy of this Act to protect … the interests of participants in *private pension plans* and their beneficiaries by improving the equitable character and the soundness of such plans … [emphasis added]." Clearly, the individual life insurance policy does not fall within either of these definitions or usages of the term "pension."

An illustration which fails to inform a prospect that life insurance is being offered is considered a misrepresentation and false advertising of life insurance in violation of the National Association Of Insurance Commissioners (NAIC) Model Laws entitled Unfair Trade Practices Act and Rules Governing The Advertising Of Life Insurance, which have been adopted in many states. Determining what constitutes a "failure to inform" can be difficult. For example, it may not be sufficient to include a short reference to life insurance at the bottom of page seven of an eight page "Private Pension Plan" proposal. While this may be subject to some debate, a more important concern should be how regulators will view such sales illustrations in light of industry difficulties concerning the marketing of life insurance as a retirement plan without adequate disclosure.

The unique benefit of life insurance is its ability to provide food and clothing for a surviving family, keep them secure in their home and educate the children. Business life insurance enables a business to continue after the death of an owner and can provide funds for purchase of the deceased's business interest by the surviving owners. These noble objectives have more than justified the current tax deferred nature of the internal cash value buildup of the permanent life insurance contract. This tax deferred status should not be threatened by placing an unwarranted emphasis on its tax benefits.

To avoid the confusion and potential misrepresentation mentioned above, it is recommended that rather than "private pension," the term "life insurance in retirement planning (LIRP)" be used.

PROBATE

Although the term is now used in referring to the entire estate settlement process, "probate" originally referred to the act of proving a will before a court or other authorized person. Courts having jurisdiction over probate matters are called probate courts, surrogates courts, or orphans courts. The first step in settling an estate is to offer the will for probate. If the will is not likely to be contested, informal proceedings, usually called probate in *common form*, establish that the document offered is the valid last will of the decedent. However, if there is any doubt regarding validity, formal probate proceedings, usually known as probate in *solemn form*, are required.

After admission of the will to probate, the court appoints an executor (male) or executrix (female) and provides them with letters testamentary as evidence of their appointment. If there is no will, the court appoints an administrator (male) or adminstratrix (female) and provides them with letters of administration. The personal representative (a term including an executor, executrix, and administrator) is then qualified to carry out his duties. Typically, the personal representative will hire an attorney to advise and assist in settling the estate.

The personal representative then collects, safeguards, and manages estate assets, has assets appraised, prepares lists of assets, converts personal property into cash, distributes assets as directed by the decedent (pursuant to specific bequests in the will), disposes of business interests, publishes notices giving creditors of the estate an opportunity to file their claims, and pays death taxes, income taxes, property taxes, court costs, appraisal fees, and fees and reimbursement expenses of the personal representative and the attorney. After a court accounting (called a judicial settlement of the account) is made and accepted by the court, the personal representative makes a distribution of the net estate to the heirs as required by either the will or the statute of intestate succession (see pages 106-114).

In recent years, much has been written about the benefits of "avoiding probate." The advantages cited include avoiding fees associated with the probate process, maintaining confidentiality, better control of assets, reduction in delays, and avoiding ancillary probate of property located in another state. However, there are some distinct advantages to having an estate go through probate. For example, protection is provided beneficiaries by having a court oversee the collection and distribution of assets. By giving creditors notice and the opportunity to make claims against the estate, beneficiaries are provided with clear title to estate assets. In addition, the Uniform Probate Code, as enacted by many states, simplifies and streamlines the probate process by providing for self-proved wills, proof of a will by affidavit of witnesses, waiver of bond, and unsupervised administration.

PROFESSIONAL CORPORATION

Professional corporations are closely held corporations formed by doctors, dentists, optometrists, lawyers, and others. They may be established by an individual or by a group of professionals and are organized primarily to take advantage of the tax deductible benefits available to employees of corporations but not to sole proprietors or partners. Typically they are organized under state professional corporation and professional association acts.

A professional in a high personal tax bracket incorporates, becomes an employee of the corporation (as well as an owner-stockholder) and receives a salary from the corporation. The usual business deductions are allowed, including salaries for stockholder-employees, as well as special corporation deductions.

Professional corporations are taxed under the same rules as other corporations. However, professional corporations in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting are considered qualified personal service corporations and corporate income is taxed at a flax rate of 35 percent.

A wide variety of employee benefits are available to the stockholder-employees of a professional corporation, including accident and health plans, group term life insurance (page 208), salary allotment (page 212), executive equity (page 216), split-dollar insurance (page 224), survivor income (page 236), deferred compensation (page 240), disability income plans (page 248), health reimbursement arrangements (page 252) and tax-favored retirement plans (page 264).

State laws generally restrict ownership of stock in professional corporations to qualified professionals (as a condition of continued authorization to provide professional services). Therefore, with professional corporations it is most important to implement buy-sell agreements that prevent the transfer of stock to anyone who is a nonprofessional. In addition to providing for the sale of stock upon death, such agreements should also contain provisions for sale in the event of retirement, permanent disability, and termination of employment or professional disqualification.

While the typical choice involves either an entity purchase agreement (page 130) or a cross purchase agreement (page 134), hybrid arrangements involving “wait and see” buy/sell agreements (page 146) and partial stock redemptions (page 154) are also used. Whichever method is chosen, adequate funding with life insurance will provide funds to meet the underlying obligations.

PROFIT SHARING PLAN

Profit sharing plans are often used by employers to distribute profits to their employees. Employer contributions to a profit sharing plan can be entirely discretionary, made according to a formula provision, or a combination of both. If on a discretionary basis, then the employer determines each year whether or not to make contributions to the plan (but a failure to make "recurring and substantial" contributions could result in disqualification of the plan). It is not necessary that the employer actually have current or accumulated profits. If on a formula basis, then contributions are made under a formula typically tied to employer profits (e.g., 5 percent of net profits after taxes, 10 percent of gross profits in excess of $100,000, or some other profit-driven formula). In either case, the employer can deduct up to 25 percent of total payroll of plan participants.

Once the amount of contribution is determined, it is then allocated among the participants' individual accounts under a nondiscriminatory formula that must be definite and predetermined. For example, each participant might receive an allocation of a percentage determined by comparing his compensation to the total compensation of all plan participants. If the employer's total contribution to the plan was $100,000, and the participant's $150,000 of compensation represented 15 percent of the $1,000,000 total payroll, then the allocation to his account would be $15,000 ($100,000 x .15 = $15,000). For 2015, the maximum compensation base for any participant is limited to $265,000. An overall "annual additions" limit for defined contribution plans limits each participant to the lesser of $53,000 or 100 percent of compensation. In determining this allocation formula integration with Social Security is allowed under most plans.

Upon the participant's termination or retirement, benefits under the plan consist of the participant's account value. This account value reflects total employer contributions, forfeitures from other plan participants, and returns on plan investments (i.e., interest, dividends and capital gains). As with a money purchase pension plan, the employee/participant bears the risks associated with investment performance. In addition, because employer contributions and profits are not assured, unlike defined benefit or money purchase pension plans, the employee is unable to project with any certainty his account values at retirement. In contrast to pension plans, certain profit sharing plans can offer participants the opportunity to take "in-service distributions" prior to retirement (subject to a 10-percent early withdrawal tax penalty prior to age 59½). In order to avoid this penalty, profit sharing plans sometimes allow participants access to account funds through plan loans at reasonable rates of interest and within specified limits.

See also, the discussion of Qualified Retirement Plans on page 519, and Life Insurance in Qualified Plans on pages 436-437.

PRUDENT INVESTOR RULE

Under the Uniform Prudent Investor Act of 1994, the prudent *investor* rule replaced the prudent *person* rule (the prudent person rule is also known as the prudent *man* rule). A majority of states have now enacted some form of the prudent investor rule.

With its focus on minimizing risk, the prudent person rule forces trustees to adopt conservative fixed-income approaches to investing trust assets. Such a conservative approach may well be appropriate for the small-to-mid-size trust whose primary function is to provide support for the current beneficiary (e.g., a marital deduction trust for the support of a surviving spouse, as in the chart on page 25). However, with larger trusts, application of the rule often results in underperforming investments and dissatisfied life and remainder beneficiaries (amusingly referred to as the trustee's duty to "disappoint equally").

State Principal and Income Acts further compounded the problem. These statutes defined "income" to include dividends, interest, and rents, but not capital gains. As a result, investment decisions were often driven by the character of the return, rather then the rate of return (e.g., trustees could distribute to income beneficiaries interest from low-yield certificates of deposit, but were prohibited from using capital gain from highly appreciated stock). The Uniform Principal and Income Act of 1997 gives trustees the authority to allocate principal to income, but it has not been adopted in many states.

Under the prudent investor rule, a trustee is required to develop an overall investment strategy having risk and return objectives reasonably suited to the trust and its beneficiaries. The trustee is to be judged by considering the performance of the portfolio as a whole, rather than individual investments. Although the trustee may delegate investment functions, there remains a duty to review and monitor overall performance. Consistent with modern portfolio analysis, the trustee may invest for capital appreciation in a diversified portfolio of equity and growth stocks. A reduction in the risk of loss is achieved by a reasonable diversification of investments. Because the trustee has a positive duty to reduce investment costs, passive investment strategies are permitted (e.g., the purchase of indexed mutual funds). It is appropriate for the trustee to seek to maintain the beneficiaries' purchasing power, and the tax implications of trust investments and distributions may be considered. Clearly, the flexibility provided by the prudent investor rule enables a trustee to better serve all beneficiaries and sizes of trusts.

Some planners have suggested that a total return unitrust can take maximum advantage of this flexibility. As with the charitable remainder unitrust, the total return unitrust requires the trustee to pay a fixed percentage of the trust principal to the life beneficiary each year. See the discussion of the total return unitrust on page 571.

QUALIFIED CONSERVATION EASEMENT

The executor of a decedent may elect on the estate tax return to exclude from the decedent's taxable estate up to 40 percent of the value of any land subject to a "qualified conservation easement." In addition to meeting the requirements of a "qualified conservation contribution," the land must be located within the United States or its possessions and must have been owned by the decedent or a member of his family for 3 years. The American Taxpayer Relief Act of 2012 permanently repealed geographic limitations within the United States that otherwise would have restricted the exclusion. The exclusion is generally not available when the property is debt-financed or the donor has retained development rights (i.e., the donor cannot retain the right to develop property for general recreational use by the public, such as a ski resort). The granting of the easement can be made by the decedent before death or by the decedent's executor.

The exclusion amount is limited to $500,000. The 40-percent exclusion percentage is reduced by 2 percent for each percentage point by which the value of the qualified conservation is less than 30 percent of the value of the land. For example, assume that property with a basis of $500,000 has a value of $1,000,000 before an easement is granted and the easement reduces the value of the property to $750,000, a reduction of 25 percent. This is 5 percent less than the minimum 30 percent threshold. Therefore, the 40 percent exclusion must be reduced by 10 percent to 30 percent (40 − (5 × 2)). The property is included in the estate at a reduced value of $525,000 ($750,000 × .30 = $225,000 reduction; $750,000 − $225,000 = $525,000 reduced value). The value of the property excluded from the decedent's estate under this provision does not receive a step-up in basis. This means the new basis is $675,000 ($525,000 stepped-up basis plus $150,000 carryover basis attributable to fact that 30 percent of the property was excluded from the gross estate; $500,000 × .30 = $150,000).

A "qualified conservation contribution" requires that the donor convey a qualified real property interest to a qualified organization exclusively for conservation purposes. A taxpayer who makes such a contribution may take a charitable income tax deduction equal to the difference in the value of the land immediately before and after the easement is placed on the property (i.e., the loss of value due to the placement of the easement). A portion of the income tax savings might be used to fund a wealth replacement trust for family members (as in the chart on page 55).

Granting a conservation easement during lifetime can provide the property owner with an income tax deduction plus a potential estate tax savings attributable to both the easement's depressing the value of the property and to the partial exclusion of that reduced value from the gross estate. However, because the exclusion reduces the adjusted gross estate, it could affect qualification for a partial stock redemption (page 154), estate tax deferral (page 373), and special use valuation (page 525).

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QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

ERISA and the Code generally do not permit retirement benefits under a qualified retirement plan to be assigned or transferred to another person. As an exception to this rule, in order to satisfy family support or marital property obligations, a qualified domestic relations order (QDRO) is allowed to create or recognize the existence of an alternate payee's right to receive benefits under a pension plan. An alternate payee can be a spouse, former spouse, child, or other dependent.

A QDRO must contain the following information: (1) the name and last known mailing address of the participant and each alternate payee; (2) the name of each plan to which the order applies; (3) the dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee; and (4) the number of payments or time period to which the order applies. A QDRO may be included as part of a divorce decree or court-approved property settlement, or issued as a separate order. It cannot provide for benefits that are not otherwise available under the plan, nor can it increase benefits payable under the plan.

Pension plans are required to establish written procedures relating to QDROs. The administrator of the pension plan that provides the benefits affected by an order is initially responsible for determining whether a domestic relations order is a QDRO. Intervening events, such as a participant's retirement, remarriage, or death, or the death of a nonparticipant spouse, can complicate the division of property interests and even result in a loss of anticipated benefits. Therefore, it is very important that a QDRO be filed in a complete and timely manner.

Under the Code transfers "incident to a divorce" are generally not taxable to either spouse. Distributions made to an alternate payee under a QDRO are not subject to the 10-percent-penalty tax normally applied to *premature distributions* from qualified retirement plans (i.e., distributions before the participant reaches age 59½). For the purpose of determining required *minimum distributions*, if the nonparticipant spouse's share is segregated (i.e., accounted for separately), the required distributions will be calculated without regard to the participant's portion of the account, except that distributions must begin by the participant's required beginning date. See pages 430-432 and 543.

The Department of Labor is a very good resource for information and forms pertaining to QDROs. For example, see www.dol.gov/ebsa/Publications/qdros.html.

QUALIFIED DOMESTIC TRUST

The federal estate tax is imposed on the taxable estate of every resident of the United States, wherever the property is located, and whether the decedent is a citizen or a noncitizen. In order to prevent a noncitizen surviving spouse from leaving and removing property from the United States, the unlimited marital deduction is not available, unless: (1) the noncitizen surviving spouse becomes a citizen prior to the time for filing the deceased spouse's federal estate tax return; or (2) the property is passed to a qualified domestic trust (QDOT). In short, no federal estate tax marital deduction is available when the surviving spouse is a noncitizen, unless use is made of a QDOT.

Both probate and nonprobate property will qualify for QDOT treatment if transferred directly from the decedent to the QDOT, or irrevocably assigned to the QDOT prior to the time that the federal estate tax return is filed. However, it is not necessary that property be placed in the QDOT in any particular fashion or by any particular person.

The requirements for a QDOT are: (1) there must be an irrevocable election for QDOT treatment; (2) the trust must require that at least one trustee be a U.S. citizen and that no distribution can be made unless such trustee has the right to withhold any estate tax which may become due; (3) the transfer must otherwise qualify as one which would be eligible for the marital deduction; and (4) specific additional procedural requirements must be met in order to ensure collection of the estate tax.

Events that trigger an estate tax on assets placed in a QDOT include: (1) failure of the QDOT to meet any of the above requirements; (2) the surviving spouse's death; or (3) any payment to the surviving spouse other than income or a "hardship" distribution. The surviving spouse cannot be given a power to invade the trust corpus unless the U.S. trustee can withhold any estate tax from the distribution (compare chart on page 25).

When property previously placed in a QDOT becomes subject to estate taxes, it is taxed using the marginal estate tax rate of the deceased citizen spouse. This means that although the unified credit is available to the surviving noncitizen spouse, it cannot be used unless the surviving spouse dies in possession of a separate estate.

There is available a gift tax exclusion which allows for annual tax-free transfers of up to $147,000 (as indexed in 2015 for inflation) to a noncitizen spouse. Taking advantage of this annual exclusion will create a separate estate for the noncitizen spouse, part of which could be used to purchase life insurance on the citizen spouse. Provided the noncitizen spouse was both policy owner and beneficiary, the life insurance proceeds would not be included in the estate of the insured citizen spouse. This would diminish the need to fund a QDOT in order to provide support for the surviving noncitizen spouse.

See also, Noncitizen Estate Planning, page 487.

QUALIFIED LONG-TERM CARE INSURANCE

A "qualified" long-term care insurance contract: (1) must provide only coverage for "qualified long-term care services"; (2) cannot pay or reimburse for services covered under Medicare; (3) must be guaranteed renewable; (4) cannot provide a cash surrender value; (5) must apply premium refunds or dividends to either reduce future premiums or increase future benefits; and (6) must satisfy consumer protection provisions, disclosure and nonforfeitability requirements as set forth by the National Association of Insurance Commissioners (NAIC).

Qualified long-term care services are defined as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, which are required by a chronically ill individual and are provided under a plan of care set forth by a licensed health care practitioner. A person is considered "chronically ill" if certified by a health care professional as unable to perform for a period of at least 90 days, without substantial assistance, at least two activities of daily living (i.e., eating, toileting, transferring, bathing, dressing, and continence) or requires substantial supervision to protect himself from threats to health and safety due to a "severe cognitive impairment" (i.e., a deterioration or loss of intellectual capacity that places the individual in jeopardy of harming self or others).

Beneficial tax treatment is afforded to a *qualified* long-term care insurance contract. (There is uncertainty regarding the tax treatment of *nonqualified* long-term care contracts issued after the enactment of the Health Insurance Portability and Accountability Act of 1996.)

Premiums. *Individuals* can deduct premiums as medical expenses, but the deduction is limited to expenses in excess of 7.5 percent of adjusted gross income. This deduction for premiums paid is further subject in 2015 to the following age-based limits: $380 if age 40 or less; $710 if age 41 through 50; $1,430 if age 51 through 60; $3,800 if age 61 through 70; and $4,750 if age 71 and over (these limits are indexed for inflation). Subject to these age-based limits, *self-employed individuals* can deduct 100 percent of premiums. Apparently premiums paid by an *employer* for a nonowner employee are fully deductible by the employer, are not includable in the employee's income, and are subject only to "reasonable compensation" limits.

Benefits. Amounts received from a qualified long-term care contract in 2015 are generally not included in income up to the greater of $330 per day or the actual costs incurred. It is not necessary to prove a need for medical care in order to deduct unreimbursed long-term care expenses for nursing homes, assisted-living facilities, adult homes and home care. This is very much to the taxpayer's advantage.

QUALIFIED PERSONAL RESIDENCE TRUST

A qualified personal residence trust, also referred to as a "residence GRIT," is created by transferring a residence, or a second home, into a split interest trust for a specific period of time, typically between 10 and 20 years. The principal advantages of such a trust include transfer of the property at a low gift tax value and shifting of future appreciation out of the grantor's estate, provided he lives to the end of the trust term.

At the time of the transfer, the value of the gift is determined by the value of the remainder interest in the residence calculated using actuarial tables (i.e., the value of the property is discounted for the fact that it will not be available to the remainderperson for many years). The grantor can also transfer limited amounts of cash to the trust in order to service debt and maintain the residence. The grantor can serve as trustee. Although a taxable gift is made when establishing a qualified personal residence trust, the value of the gift is minimized by the remainder interest calculations, and the grantor can avoid actually paying gift taxes by utilizing unused unified credit. However, because the gift is of a future interest, the annual exclusion is not available (see page 46).

Unlike other transfers with a retained interest, the grantor can continue to use the residence throughout the term of years established by the trust, yet the property will be removed from his estate provided he lives to the end of the term (the same as a GRIT, see page 415). Although death prior to the termination of the trust would cause the full date of death value to be brought back into the grantor's estate, purchase of life insurance on the grantor's life could provide for payment of any estate taxes. A desire to lengthen the trust term in order to lower gift tax exposure upon establishing the trust must be balanced against the loss of all estate tax benefits if the grantor dies before the end of the trust term.

The trust can also give the grantor a contingent reversionary interest, which will cause the residence to revert back into his estate in case of death before the end of the term. With such a provision, the grantor could utilize the marital deduction by passing the residence to a surviving spouse, thereby postponing estate taxes, while at the same time causing the trust to be classified a "grantor trust," which would allow the grantor to deduct property taxes and mortgage interest on his own tax return during the term of the trust. The existence of such a reversionary interest would also cause a further reduction in the value of the gift, measured by the probability that the grantor would not survive the term of the trust.

Upon the termination of the trust, the grantor may wish to continue living in the residence. To accomplish this, he can either rent the residence from the remainderperson, or purchase the residence prior to the expiration of the trust term (for a fair rental rate or a fair market value). However, regulations prohibit a sale of the residence to the grantor or the grantor's spouse during the original term or while a grantor trust.

QUALIFIED RETIREMENT PLANS

A qualified retirement plan, also referred to as a "qualified plan," is a tax-favored retirement arrangement established by an employer that is designed to satisfy the requirements of Section 401 of the Internal Revenue Code. The employer may be a corporation, a partnership or a sole proprietorship. The "plan" is the document that sets forth in writing the rules by which the plan operates, such as how employees become participants and the method of calculating the benefits to which they become entitled. Contributions to the plan are transferred to a trustee or insurance company that holds and invests them until they are distributed upon the participant's termination of employment, retirement, or death. Assuming the necessary requirements are met, contributions are deductible to the employer (within limits) and are not currently taxable to the employee/participant. Earnings on plan investments grow tax-deferred and are not taxable to the employee until withdrawn or distributed.

Types Of Qualified Retirement Plans*		
	Defined Contribution	**Defined Benefit**
Pension	Money Purchase Pension Plan [484] Target Benefit Plan [567]	Defined Benefit Pension Plan [374] Cash Balance Pension Plan [344] 412 (i) Plan [276]
Profit Sharing	Profit Sharing Plan [512] 401(k) Plan [268] Stock Bonus Plan [562] ESOP [391] Age-Weighted Profit Sharing Plan [333] Savings/Thrift Plan [542]	n/a
* Numbers in brackets [ ] indicate page numbers.		

Qualified retirement plans can be categorized in a number of ways. One method distinguishes between plans according to the nature of the employer's obligation. Under a **defined contribution** plan the employer makes specific contributions to the plan, after which the participant's retirement benefits are determined by the account value at retirement (i.e., the *employee* bears the investment risk). In contrast, under a **defined benefit** plan the employer is obligated to provide a specific retirement benefit to the participant (i.e., the *employer* bears the investment risk).

Another way of categorizing plans distinguishes between them according to whether employer contributions can be tied to employer profits. Under a **pension** plan the employer is obligated to provide a "definitely determinable benefit." However, under a **profit sharing** plan employer contributions can be completely discretionary and based on employer profits.

QUALIFIED SMALL BUSINESS STOCK

In order to raise capital, small businesses may designate certain stock as "qualified small business stock." Provided all statutory requirements are met, noncorporate investors may exclude from gross income 100 percent of their gain from the sale of stock that has been acquired from January 1, 2012, to January 1, 2014 (as provided by the American Taxpayer Relief Act of 2012). Gain that may be excluded from a single issuer of stock is limited to the greater of 10 times the stockholder's adjusted basis in the stock or $10 million (but reduced to $5 million for married couples filing separately). The benefits of the small business stock exclusion can be passed by gift or inheritance.

In order to be eligible for this favorable tax treatment, the following qualifications must be met:

1. The stock must have been issued by a domestic C corporation after August 10, 1993.

2. The stock must be acquired at its original issue and held for more than five years.

3. The issuing corporation must be engaged in a "qualified trade or business," which is defined to be *any trade or business other than* those involved in:

   a. the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees;
   b. banking, insurance, financing, leasing, investing, or similar business;
   c. farming (including the business of raising or harvesting trees);
   d. the production or extraction of products for which a percentage depletion deduction is allowed; or
   e. operating a hotel, motel, restaurant, or similar business.

If all requirements are met the corporation need not be a newly formed business. But stock is not eligible if the corporation, within certain periods of time, purchases stock from the stockholder, or persons related to the stockholder.

There is an active business requirement, meaning that the corporation must use at least 80 percent by value of its assets in the active conduct of one or more qualified trades or businesses. Also, there is a gross asset test requiring that, both before and immediately after the stock's issue date, the corporation's gross assets cannot exceed $50 million. The corporation must also agree to submit periodic reports documenting its status as a qualified small business.

RABBI TRUST

The term "rabbi" trust comes from an IRS private letter ruling involving a trust established by a religious organization for its rabbi. A rabbi trust is used to fund non-qualified deferred compensation arrangements and provide plan participants with some measure of security that promised future benefits will be paid. Because the funds placed in such a trust continue to be subject to claims of the employer's creditors, the security is in large measure psychological; generally, the employer's duty to pay the benefits to the employee at the designated time from whatever source is a binding legal obligation.

However, because the trust is generally made *irrevocable*, it does protect the employee from being denied payment of the funds by a change of management, as might occur under the conditions of a hostile takeover.

The rabbi trust has been a popular device for "informally" funding non-qualified deferred compensation. In fact, this popularity caused the Internal Revenue Service to publish a model trust instrument in Revenue Procedure 92-64. The model trust serves as a safe harbor for employers adopting rabbi trusts; used properly, the model trust will not cause current taxation of employees under either the constructive receipt or the economic benefit doctrines.

The law provides two specific prohibitions relative to the funding of non-qualified deferred compensation plans. The first rule prohibits the setting aside of assets in an off-shore trust for purposes of paying deferred compensation. (This prevents the use of offshore rabbi trusts but should not affect domestic rabbi trusts.) The second rule prohibits the use of triggers designed to protect assets set aside to pay deferred compensation upon a change in the employer's financial health. A properly drafted rabbi trust should not run afoul of this second rule, provided it protects the employee from his employer's refusal to honor the deferred compensation (i.e., offers protection from the *contract* risk, but not the *credit* risk). See also, the discussion of Section 409A on page 546.

Substantial penalties make it important not to violate these prohibitions when drafting, implementing, and funding deferred compensation plans. Violating them can result in an additional 20 percent tax and imposition of interest at a rate that is 1 percent higher than the normal underpayment rate. These rules apply to any amounts deferred after December 31, 2004, and to any plan that is "materially modified" after October 3, 2004.

RECESSIONARY ESTATE PLANNING

In general, investment real estate, publicly traded securities, and closely held business have undergone major reductions in value over the past few years. Likewise, interest rates are at historic lows in an attempt to revive a struggling economy. This combination of depressed asset values and low interest rates create unique estate planning opportunities. These low interest rates are reflected in the "Section 7520 rate." (Section 7520 of the Internal Revenue Code requires the use of a set of actuarial tables for valuing many popular forms of asset transfers used in estate planning.)

Things To Consider

Specific Bequests In Wills. Review to make sure the value assumptions underlying them are still valid (e.g., should there be a change in light of falling stock values).

Trust Funding. Review wills to determine whether surviving spouse will continue to have adequate resources with current funding of the family trust (i.e., consider both changing tax laws and falling value of spouse's separate resources).

Sell Depreciated Assets, Then Make Gifts. Because of the carryover basis, donees are unable to recognize losses that were available to the donor (i.e., when fair market value was less than adjusted basis prior to the gift). Assets with built-in losses should be sold by the owner and the net proceeds used to take advantage of the gift tax laws. See chart on page 47.

Asset Valuations. Review current values where assets have been allocated between spouses in order to take maximum advantage of the applicable exclusion amount with bypass trusts. If appropriate, reallocate assets between spouses.

Grantor Retained Annuity Trust (GRAT). Donor creates a trust and retains a right to receive fixed annual annuity payments. Upon trust termination, the remainder interest is paid to trust beneficiaries. The lower Section 7520 rate produces a higher value for the retained annuity interest (i.e., larger retained interest reduces value of gift) and a lower value for the remainder interest (i.e., uses less gift tax unified credit). However, the transfer tax benefits of the GRAT depend upon the transferred property producing a return in excess of the Section 7520 rate. See chart on page 59 and comparison with GRITs and GRUTs on page 415.

Charitable Lead Annuity Trust (CLAT). Donor creates a trust and a charity receives annual annuity payments. Upon trust termination, the principal is paid to individual beneficiaries. The lower Section 7520 rate produces a higher value for the annuity interest to the charity (i.e., higher charitable deduction) and a lower value for the remainder interest to the individual beneficiaries (i.e., uses less gift tax unified credit). Subsequent appreciation of the depressed property held in a CLAT is excluded from the donor's estate.

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RECESSIONARY ESTATE PLANNING (continued)

Self-Cancelling Installment Note (SCIN). The installment debt obligation involves both a risk premium and market interest. Both of these benefit from a low interest rate environment. See page 550.

Private Annuity. A decrease in the Section 7520 interest rate lowers the payments from child to parent, thereby increasing the efficacy of the private annuity as a wealth transfer technique. See footnote 1 on page 45 and page 507.

Installment Sale To Intentionally Defective Grantor Trust. Grantor creates trust that is defective for income taxes purposes (i.e., grantor will be taxed on all trust income), but irrevocable for gift and estate tax purposes (i.e., growth of trust is excluded from grantor's estate). Once established, the grantor makes a gift to the trust, equal in value to 10 percent or more of the value of the property to be sold to the trust by the grantor in a subsequent installment sale. Property that is currently depressed in value with high appreciation potential is ideally suited for this purpose. For details see the chart on page 67 and discussion of grantor trust rules on page 414.

Things That Might Not Work

Qualified Personal Residence Trust (QPRT) – A depressed housing market reduces the value of the home (good), but low interest rates increases the value of the gift to heirs (not good). An analysis is required to determine whether this technique is viable. See page 518.

Charitable Remainder Annuity Trust (CRAT). The CRAT is the mirror image of the CLAT. Donor creates a trust and retains an annuity for a period of years with a charity as remainder beneficiary. A decrease in the Section 7520 interest rate reduces the charitable deduction. See the chart on page 55 and comparison with other charitable trusts on page 347.

Charitable Gift Annuities. As with the CRAT, the lower Section 7520 rates reduce the value of the remainder interest available for the charity. This results in a lower charitable deduction. Also, in response to the economic downturn the American Council on Gift Annuities has lowered the suggested charitable gift annuity rates, meaning that the purchasers of charitable gift annuities will receive lower payout rates. Despite these negatives, many donors with strong charitable commitments will continue to purchase charitably gift annuities. See page 345.

Things That Will Not Work

Gifts Of Loss Property – Generally, if property would result in a loss if it is sold, it should not be given away (i.e., tax basis exceeds potential sales price). A donee receives a carryover basis and would be unable to take the loss. The donor should sell the property, take a income tax deduction for the loss, and give the sales proceeds to the donee.

RECIPROCAL TRUST DOCTRINE

Irrevocable trusts are powerful estate planning tools for protecting valuable assets for the benefit of loved ones. These trusts are typically created in pairs (such as when a married couple creates two life insurance trusts, each for the benefit of the other spouse and the children). This has been especially true in recent years when many affluent married couples hastened to utilize the $5 million lifetime gift tax exemption in anticipation of the exemption being decreased (it did not happen). These trusts are often created as so-called Spousal Access Trusts (see discussion, page 559).

The reciprocal trust doctrine is a means by which the IRS or a court can ignore trusts created by two grantors (such as a husband and wife) and hold that the economic substance of the transaction is the same as if each grantor had transferred the assets to a trust for his or her own benefit (e.g., the assets are still taxable in his or her estate). Simply stated, the reciprocal trust doctrine is applied to prevent tax avoidance.

The reciprocal trust doctrine is easily demonstrated by an example. Assume Andy and Brenda are husband and wife, and Andy wishes to use his $5 million estate and gift tax exemption to create an irrevocable trust for the benefit of Brenda (his wife) and their children. Likewise, Brenda wishes to use her $5 million exemption to create an identical (or very similar) trust for the benefit of Andy (her husband) and their children.

Based upon the holdings of a number of court cases (including: *Lehman v. Commissioner*, 2nd Cir. 1939 and *Sather v. Commissioner*, 8th Cir. 2001), the IRS could conclude that the economic substance of the transaction is the same as if Andy had created a trust for the benefit of himself and their children and that Brenda had created a trust for the benefit of herself and their children. In such a case, Andy and Brenda would be incorrect in believing that they had gotten the future appreciation on the $5 million transferred to each trust out of each of their estates for estate tax purposes. Imagine the possible tax impact of the application of this doctrine if the trusts were ignored and the assets in the trusts appreciated to fifteen or twenty million each during Andy and Brenda's lifetimes.

The reciprocal trust doctrine is most likely to be invoked when two trusts are identical. In attempting to avoid application of the doctrine, trusts are differentiated in a variety of ways (e.g., by time of creation, type of asset contributed, and dispositive terms). Unfortunately, no exact objective standard exists for determining when the reciprocal trust doctrine will or will not be applied.

REDUCED VALUATION

An executor of an estate may elect special methods for valuing real property used in a farm, trade, or business. When available, these methods allow the real property to be valued on the basis of current use, rather than on its fair market value.

To qualify, the following requirements must be met:

1. As of the decedent's death, the real property must have been involved in a "qualified use"; i.e., used as a farm for farming purposes, or in a trade or business.

2. The adjusted value of all business or farm property, *both real and personal*, must be at least 50 percent of the adjusted gross estate.

3. The adjusted value of the business or farm *real property* must be at least 25 percent of the adjusted gross estate.

4. The decedent, or a member of his family, must have owned and been a "material participant" in the operation of the business or farm for at least 5 of the last 8 years preceding the earliest of the decedent's death, disability, or retirement (rental property does not qualify).

5. The business or farm must pass to a "qualified heir," including, among others, his spouse and immediate family.

In determining current use value the following factors apply:

1. The capitalization of the *fair rental value* of the land for farmland or closely held business purposes.

2. The capitalization of *income* that the land can be expected to yield for farming or closely held business purposes.

3. Actual assessed land values if the state provides a use value assessment law for such land.

4. Comparable sales of other farm or closely held business land located in an area where nonagricultural use is not a significant factor in determining the sales price.

5. Any other factors that could be fairly used to determine the farm or closely held business value of the land.

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REDUCED VALUATION (continued)

Alternatively, when farm land is to be valued, the executor can elect a formula utilizing the average annual Gross Cash Rental for comparable land, less the average annual State and Local Real Estate Taxes for comparable land, divided by the average annual effective Interest Rate For Federal Land Bank Loans in the farm credit bank district in which the property is located ~~(from 5.15 percent to 6.19 percent in 2014)~~. The formula reads:

$$\frac{\text{Gross Cash Rental - State and Local Real Estate Taxes}}{\text{Interest Rate for Federal Land Bank Loans}}$$

Before relying on the reduced valuation provisions, a business owner should give serious consideration to the following qualifications and restrictions that are imposed:

1. The special methods for valuation cannot decrease the estate by more than $1,100,000 (as adjusted in 2015 for inflation, rounded down to the next lowest multiple of $10,000).

2. The business or farm must be continuously operated by a qualified heir for 10 years after the decedent's death (a 2-year grace period immediately following death is available, but it extends the recapture date). It is permissible to make a cash lease to a member of the lineal descendant's family, who then continues to operate the business or farm.

3. If the property is sold or the use is discontinued within 10 years, the taxes must be recomputed based upon the original fair market value (a sale to another qualified heir does not trigger recapture).

4. The qualified heir who receives the property must sign an agreement to be *personally liable* for the additional tax. It is due and payable within 6 months after the date of sale or cessation of the use.

REINSURANCE

In its simplest form, reinsurance is the sharing of a risk by a number of insurance companies so that the mortality and profits of any one company are not greatly impacted by its claims experience. A reinsurance agreement between companies is often referred to as a reinsurance "treaty." The three main elements involved in reinsurance are retention limits, automatic reinsurance and facultative reinsurance.

"Retention" is the face amount of coverage on one life that a company retains. The amount retained is influenced by numerous considerations, including capital, surplus, insurance in force, and average policy size.

Under an **automatic** agreement the primary or ceding company (i.e., the company sending the risk out for reinsurance) must offer – and the reinsurer must accept – all risks that fall within the terms of the reinsurance agreement. The primary company does not provide the reinsurer with underwriting information. For example, the automatic agreement might provide that the reinsurer will accept the lesser of $3,000,000 or four times the primary company's retention limit, provided the total amount of insurance in force and applied for in all companies is $12,000,000 or less. If the total amount of insurance exceeds these limits then the automatic agreement is not effective and the companies resort to facultative reinsurance.

Under a **facultative** agreement the primary carrier submits the application and underwriting information to the reinsurer for review. The reinsurer then makes an independent underwriting decision and communicates its offer to the primary carrier. With larger or special risks the reinsurer may itself have special reinsurance arrangements.

"Best offer" underwriting is often used in substandard cases and typically involves sending the case to a number of reinsurance companies for underwriting. The primary company then issues the case utilizing the best offer obtained.

Reinsurers may refuse to consider a case if they receive notice that multiple applications have been submitted to a number of primary insurance companies. Because of this it is most important not to submit applications on the same insured to multiple companies unless they are fully informed of the submissions.

See also the discussion of financial underwriting on page 410.

REMAINDER INTEREST TRANSACTION (RIT)

Considered an aggressive estate planning technique, the RIT has been used as a means of shifting the future appreciation of an asset from one individual to another. As with GRITs, when the shift occurs between certain family members, the RIT falls squarely within the scope of the Chapter 14 special valuation rules (see Estate Freezes, pages 402-403, and **Q 781**, *Tax Facts on Insurance & Employee Benefits (2015)*). However, a special rule allows for market valuation of RITs involving tangible property with respect to which the non-exercise of rights under the term interest would not have a substantial effect on the valuation of the remainder interest (e.g., non-income producing property such as a painting or undeveloped real estate).

Remainder interest transactions have taken advantage of the fact that property interests can be divided between *life estates* (i.e., the right to the use of property for life) and *remainder interests* (i.e., the right to ownership of property once the life estate of another has terminated). To the extent they are still viable, a RIT for a *term of years*, rather than a life estate, would exclude the property from an estate provided death occurs after the end of the term of years.

Where still viable, it is important that the sales contract for a RIT involving the retention of a life estate require that the purchaser (the remainderperson) pay full and adequate consideration for the remainder interest (there is a split in the courts regarding whether adequate consideration should be measured by the remainder interest or by the value of the entire property). Without payment of full and adequate consideration, the IRS may treat the whole transaction as a gift with a retained life estate, the result being that the full date-of-death value of the property is included in the seller's estate.

RETIRED LIVES RESERVES (RLR)

Retired lives reserves are funds that can be established to continue group term life insurance for retired employees. Contributions to the fund are generally tax deductible to the employer, yet not taxable income to the employee. Upon either retirement or permanent disability, the employee can continue to receive limited amounts of tax-free coverage. In regard to the exclusion of the first $50,000 of coverage, see the discussion on page 208.

If the illustrated interest rate assumptions are not achieved, or if the employees live beyond actuarial life expectancy, the employer must make additional payments to the fund in order to provide the anticipated death benefits for the retired employees.

Much of the attractiveness of RLR rested upon the tax deductibility of corporate contributions to fund large amounts of insurance for key employees. Because of this, the RLR concept lost favor with passage of the Deficit Reduction Act of 1984, which imposed the following restrictions on RLR plans:

1. Generally, no deduction can be taken for RLR funding for insurance in excess of $50,000.
2. A separate account must be established for each covered key employee and benefits paid only from that separate account.
3. The group term rate for excess coverage after retirement must be reported in income (i.e., coverage over $50,000).
4. In a discriminatory plan the higher of the Table I or the actual term cost of the coverage (including the first $50,000) is taxable to retired key employees.
5. There is a 100-percent excise tax on funds returned to the employer to the extent they are attributable to deductible contributions.

Because of these severe restrictions, it may be advisable to consider other alternatives for funding personal insurance for key employees. Executive Equity (chart, page 217), Restrictive Bonus Plan (chart, page 221) and Split-Dollar Insurance (chart, page 225) offer viable alternatives to RLR.

RETIREMENT INCOME PLANNING

Retirees are living longer, healthier, and more active lives. For example, according to the 2000 Annuity Mortality Tables, the life expectancy of a male age 65 is 20.4 years. This means that there is a 50 percent chance that a 65-year-old male will live beyond age 85. Under these same tables the life expectancy of a female age 65 is 23.0 years, meaning that there is a 50 percent chance that a 65-year-old female will live to at least age 88. Further, with a couple who are both age 65, there is a 50 percent chance that one or both of them will live beyond age 92. Such long life expectancies make it essential that adequate retirement income planning take place.

Retirement income planning requires a shift of focus from performance and accumulation to withdrawal and sustainability. The basic objective is to assure that the retiree will receive an *inflation-adjusted stream of income that will not be outlived*. In retirement jargon … a "sustainable withdrawal strategy" must be developed.

Determining resources. The first step involves identifying potential sources of retirement income. Sources of income, and assets that can be converted into income, include:

1. Government benefits such as Social Security and veteran benefits.
2. Tax-favored retirement plans including:
    a. Qualified retirement plans, both *defined contribution plans* (pension plans such as money purchase and target benefit plans, and profit sharing plans such as 401(k) plans and savings/thrift plans) and *defined benefit plans* (traditional defined benefit plans, cash balance plans, and 412(i) plans).
    b. Individual retirement arrangements, such as traditional IRAs, Roth IRAs, SIMPLE IRAs, and simplified employee pension plans (SEPs).
    c. 403(b) plans and 457 plans.
3. Cash reserves including checking accounts, money market accounts, regular savings, CDs, and life insurance cash values.
4. Income assets such as bonds, fixed annuities, installment payments, and nonqualified deferred compensation plans.
5. Equity assets including stocks, mutual funds, variable annuities, and business interests.
6. Tangible assets such as real estate investments (primary residence, second home and commercial rental property).
7. Anticipated inheritances and life insurance death benefits.

Establishing a plan. The planning process is significantly different and can be more complex than that needed when accumulating assets. However,

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RETIREMENT INCOME PLANNING (continued)

having a well thought out plan can bring peace of mind to those who would otherwise be uneasy about beginning the drawdown of a lifetime's savings and investments. There are a lot of variables to be considered and tradeoffs to be made. For example, the process will likely include:

1. Determining *retirement income needs* using realistic inflation assumptions (typically between 2 and 4 percent per year, but increases in healthcare costs have been substantially higher). Life expectancies must be estimated. Lifestyle choices and increases in the years of healthy life during retirement will significantly impact income needs (see table on page 593). The spending lifecycle of persons during their retirement years must be anticipated. For example, in the early retirement years retirees typically spend more on travel and entertainment, whereas the latter years bring increased health care expenditures.

2. Projecting realistic *rates of return on investments*, taking into consideration the retirees' time horizons and tolerance for risk. For example, because investment returns are not linear, Monte Carlo simulations are used to determine the likelihood that a particular withdrawal rate can be sustained (typically between 4 and 6 percent annually). Asset allocation, rebalancing of investments and annual plan review are essential.

3. Determining income, if any, that will come from part-time *employment* (e.g., the trend toward "phased" retirement has led the IRS to issue regulations that permit workers who are near retirement age to reduce their working hours and make up lost wages by taking in-service distributions from defined benefit plans, see 72 FR 28604).

4. Avoiding *penalties* associated with tax-deferred savings (e.g., before age 59½ withdrawals and after age 70½ distributions) and determining the impact of early retirement on Social Security retirement benefits (see page 316).

5. Evaluating and using *techniques* and *products* that are effective in meeting retirement objectives. These include using systematic withdrawal plans with mutual funds and annuities, laddering of bonds, purchasing long-term care insurance, and using reverse mortgages to access home equity. Indexed annuities can mitigate not only the longevity and inflation risks, but can reduce the investment risk by providing a guaranteed minimum income benefit.

6. Determining the tax consequences of distributions, minimizing taxes, and selecting those accounts to be drawn down first.

7. Implementing estate *plans* involving powers of attorney, wills, trusts, gifts, and asset protection.

8. Establishing and monitoring a *retirement budget*.

REVERSE MORTGAGE

A reverse mortgage is a loan against a home that requires no repayment so long as the homeowner lives in the house. With a traditional mortgage, payments *made by* the homeowner increase home equity (rising equity, falling debt); whereas, with a reverse mortgage, payments *received by* the homeowner reduce home equity (falling equity, rising debt).

The qualifications to obtain a reverse mortgage generally include: (1) all of the homeowners must be at least 62 years old; (2) the home cannot be subject to a mortgage (or the mortgage must either be paid off prior to the loan or paid from loan proceeds); and (3) the home must be the homeowner's principal residence (single family house, 2-4 housing unit, federally approved condominium, or planned unit development). Note that there are no income qualifications. The 2014 lending limit is $625,500 (i.e., the maximum portion of the home value that can be borrowed against, no matter what the appraised value may be). The limit will decline in 2015 to $417,000.

In addition to the costs found with the typical mortgage (e.g., interest charges, origination fees, and closing costs), the reverse mortgage can include an "equity sharing" or "shared appreciation" fee.

The mortgage is a "nonrecourse" loan, meaning that the amount owed can never be more than the net proceeds received from the eventual sale of the home. For example, assume that upon a homeowner's death the amount owed under the reverse mortgage is $76,000, but the amount realized from the home's sale is only $70,000. The estate is not liable for the $6,000 difference. On the other hand, if the net proceeds from the sale were $100,000, the estate would be entitled to the excess $24,000.

The most widely available reverse mortgage program is the federally insured "Home Equity Conversion Mortgage" (HECM). The amount obtained from a reverse mortgage *can vary substantially* depending upon the program selected, the interest rate, the homeowner's age, and the home's value. Funds can be paid as an immediate cash advance, a creditline account, a monthly cash advance (payable either for a specific number of years, as long as the homeowner lives in the home, or for life by purchasing a commercial annuity), or any combination of these methods. Creditline accounts can be either flat or increasing each year by a specified rate. A commercial annuity offers the advantage of ongoing income for life whether or not the home is sold, but the disadvantage of a high loan balance in case of early death (i.e., cash advance purchases annuity).

The National Center for Home Equity Conversion, an independent not-for-profit organization, is an excellent source for more information (see www.reverse.org). See also the information provided by the National Reverse Mortgage Lenders Association at www.reversemortgage.org.

Any party participating in the origination of a reverse mortgage insured by the FHA is prohibited from participating in, associating with, or employing any party participating in any other financial or insurance activity, unless certain firewalls are maintained.

RISKS – TYPES OF

There are many categories and types of risks, from physical risks to social risks, and ethical risks to monetary risks. The following risks are associated with risk management in financial and retirement planning.

1. **Market Risk** - the risk that unrelated factors will decrease the value of an investment (e.g., world events or legislation). Market risk can be lessened by diversification of investments and dollar cost averaging (see chart, page 321.

2. **Interest Rate Risk** - the risk that interest rates will rise, decreasing the value of bonds or other fixed interest rate investments.

3. **Concentration Risk** - the risk that concentration of investments in a particular stock, bond, or market segment could result in a large loss of portfolio value (e.g., investing 50 percent of a portfolio in a particular stock). This risk can be reduced by acquiring a combination of fixed and equity investments, including mutual funds.

4. **Economic Risk** - the risk that the economic environment will decrease the value of an investment or other source of income. For example, the increasing costs of the Social Security system might require a change in the amount or timing of benefits (see footnote 2, page 267).

5. **Political Risk** - the risk that the political climate will result in changes in regulations and laws that impact the economy, tax laws, and Social Security benefits.

6. **Tax Risk** - the risk that changes in the tax laws will result in greater taxes. For example, prior to 1984 Social Security benefits were free of income taxes, but under present law up to 85 percent of Social Security benefits may be subject to income taxes (see discussion, page 556).

7. **Inflation Risk** - the risk that goods and services will cost more in future years and that inflation will erode the purchasing power of fixed income or investments (see inflation adjuster, page 92, and consumer price index, page 317).

8. **Longevity Risk** - the risk that a person's longevity will result in outliving his income or suffering a loss of purchasing power (see mortality table, pages 594-595). This risk can be reduced through the purchase of life annuities and equity investments.

9. **Security Risk** - the risk that there could be a failure of a financial institution (e.g., bank or insurance company).

10. **Currency Risk** - the risk that a decrease in the underlying value of a nation's currency will reduce the purchasing power of income or investments paid in that currency.

ROTH 401(k)

The Roth 401(k) feature combines the structure of a 401(k) plan with tax benefits similar to those of a Roth IRA. Under a Roth 401(k) feature employees who make after-tax contributions may take fully tax-free withdrawals in retirement (i.e., to the extent there is a "qualified distribution" the growth is never subject to federal income taxes). This is the reverse of the traditional 401(k) which allows employees to make before-tax contributions, but then fully taxes all retirement withdrawals (see chart, page 269).

Contributions are governed by the 401(k) rules, meaning that up to $18,000 may be contributed in 2015, plus an additional $6,000 as a "catch-up" contribution if the participant is at least 50 years old. These maximum elective deferrals apply to *total* contributions to both the pre-tax and Roth accounts. Participants in 401(k) plans that have adopted Roth provisions have three choices: (1) continue to contribute only to the pre-tax account; (2) divert all contributions to the after-tax Roth account; or (3) split contributions between the two. (Note that stand-alone Roth 401(k) plans are not allowed.) Plans must provide separate accounts for the designated Roth contributions and earnings on these contributions. Unlike the Roth IRA, there are no income limits beyond which contributions may not be made (e.g., in 2015 if taxable income exceeds $195,000, a married couple filing jointly cannot make a Roth IRA contribution, see page 313). Likewise, there are no maximum age limits for participants; they need only be working for an employer offering a 401(k) plan with a Roth feature. A similar "qualified Roth contribution program" known as a Roth 403(b) plan may be made available to participants in 403(b) plans. Participants in these programs are able to designate all or a portion of their elective deferrals as Roth contributions (see also the 403(b) Plans chart on page 289).

Distributions from a Roth 401(k) are generally treated very much like distributions from Roth IRAs. Once the participant is age 59½ tax-free "qualified distributions" may be made, provided the account is at least five years old (i.e., five years have passed since the first contribution). Tax-free distributions are also allowed after the participant's disability or death. Although subject to lifetime required minimum distributions, funds in a designated Roth contribution account may be rolled over into a Roth IRA that is not subject to these requirements (see pages 535 and 587). This makes the Roth 401(k) attractive for those wishing to leave their children an income-tax-free inheritance (i.e., no taxable "income in respect of a decedent," see page 422).

The Roth 401(k) feature is likely to be most attractive to younger employees in lower tax brackets who can take advantage of many years of tax-free growth. However, for many other individuals it will not be easy to determine whether the tax-free withdrawals in retirement years will be worth the upfront cost.

ROTH IRA

The Roth IRA permits individuals in 2015 to make nondeductible contributions to an IRA of up to the lesser of 100 percent of compensation or $5,500 per year. Husband and wife may each contribute $5,500 per year provided there is sufficient compensation. An additional "catch-up" contribution of $1,000 is allowed for individuals who attain age 50 before the close of the taxable year. Unlike traditional IRAs, contributions may be made after age 70½.

As with the traditional IRA, the Roth IRA accumulates tax-deferred. Provided the account has been held for at least five years, distributions are not subject to income taxes if: (1) the owner is at least age 59½; or (2) the distribution is made after the owner's death (e.g., to a surviving spouse or children); or (3) the distribution is attributable to the owner being disabled; or (4) the distribution is for qualified first-time home buyer expenses (limited to $10,000 for both the owner and specified family members). A 10-percent-penalty tax may apply to the taxable portion of withdrawals that are not qualified (but even if withdrawals are not qualified the owner can withdraw his original nondeductible plan contributions free of both income taxes and the 10-percent-penalty tax, only the earnings are subject to these taxes). Unlike traditional IRAs, there are no requirements that distributions be started or completed by any particular date, unless the owner dies.

The annual contribution limit is reduced (dollar-for-dollar) by all contributions to a traditional IRA. Also, in 2015 the maximum yearly contribution is subject to a pro rata phaseout for taxpayers filing jointly with modified adjusted gross incomes between $183,000 and $193,000 (for single taxpayers and heads of households with modified adjusted gross incomes between $116,000 and $131,000). In contrast, with a traditional IRA if the participant is an active participant in a qualified plan the deductible phaseout limits in 2015 are $98,000 to $118,000 for taxpayers filing jointly and $61,000 to $71,000 for single taxpayers. See also, pages 310-312 and 424.

A Roth IRA may generally accept a conversion from a traditional IRA (but for tax years beginning prior to 2010, modified adjusted gross income could exceed $100,000). Distributions in excess of basis from the traditional IRA are included in gross income (but not for purposes of determining modified adjusted gross income).

The following factors might be considered when determining whether for a particular taxpayer the Roth IRA is better than a traditional IRA, or whether to make a taxable rollover to a Roth IRA: (1) the current age of the taxpayer; (2) the taxpayer's current and anticipated future marginal income tax brackets; (3) the taxpayer's need for a current income tax deduction; (4) the availability of other funds to pay the taxes on Roth IRA contributions or rollovers; and (5) anticipated reduction of taxes on Social Security income caused by receiving untaxed IRA income.

See also Roth IRA Conversion on page 536.

ROTH IRA CONVERSION

The process of converting some or all of a traditional IRA into a Roth IRA is known as a "Roth IRA conversion." There is no longer any income limit on those taxpayers who can convert (in tax years beginning on or before December 31, 2009, only individuals or couples with modified adjusted gross income of $100,000 or less could convert).

Conversion to a Roth IRA provides many advantages. While both the traditional IRA and the Roth IRA provide for tax-deferred growth of retirement savings, only the Roth IRA enables the account holder, the account holder's surviving spouse, or even the account's holders surviving children, to receive distributions free of income taxes (but the account must be held at least five years and meet additional requirements, see page 535).

In addition, since Roth IRAs are not subject to the minimum distribution requirements, no distributions are required during the account holder's lifetime (see page 430). Nor will distributions be required during the surviving spouse's lifetime, provided the spouse is the sole designated beneficiary and elects to treat the Roth IRA as his or her own (but upon the spouse's death the account will be subject to the after-death requirements, see pages 431-432). With respect to inherited benefits: (1) a traditional IRA inherited by a spouse may be converted to a Roth IRA (but a nonspouse beneficiary may not convert a traditional IRA to a Roth IRA); and (2) a *qualified* plan benefit inherited by either a spouse or nonspouse beneficiary may be rolled over into an inherited Roth IRA (e.g., the nonspouse beneficiary of a 401(k) plan can either convert to an inherited Roth IRA or transfer the benefit to an inherited traditional IRA). See the types of Qualified Retirement Plans on page 519.

Potentially tax-free income, no minimum distributions, tax-deferred growth, and the flexibility to stretch out distributions years into the future among multiple beneficiaries all combine to offer the account holder a unique opportunity to create a permanent but flexible tax-free savings plan. With all these advantages, it might appear the decision should be relatively easy. But upon conversion, the account holder must pay *ordinary income taxes* on both the tax-deductible contributions previously made to the traditional IRA and the subsequent tax-free growth. The account holder's decision is influenced by two expectations: (1) that on any given amount distributed, less income taxes will be paid currently than in the future (e.g., as a result of higher future tax rates, fewer deductions, or more taxable income); and (2) that there will be adequate time and investment opportunity for growth within the Roth IRA to more than offset the cost of making an early payment of income taxes.

Recognizing that a conversion is a taxable event, it is generally agreed that the best time for converting is before account values appreciate and tax rates increase. Current historic low income tax rates may make a compelling

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ROTH IRA CONVERSION (continued)

case for conversion. In addition, as an added incentive, taxpayers had a one-time opportunity to defer gain from 2010 conversions and recognize it ratably over 2011 and 2012.

A traditional IRA that has been converted into a Roth IRA may be recharacterized as a traditional IRA until the due date (including extensions) of the account holder's return for the year the conversion was made. This means that the account holder has up until October 15th of the following year to decide whether to recharacterize. For example, assume that an account holding stock valued at $80,000 was converted to a Roth IRA in January of 2013. Now assume further, that by September of 2014 the stock's value fell to $65,000. By recharacterizing the conversion, the account holder can avoid having to report $80,000 of ordinary income on stock having a value of only $65,000. On the other hand, if the stock's value had increased, the account holder can let the conversion stand, report taxes on the conversion, and enjoy his or her investment returns.

Conversions may also be made from a traditional 401(k), a section 403(a) annuity plan, a section 403(b) tax-sheltered annuity, or an eligible Section 457 governmental plan. See the discussion of the Roth 401(k) on page 534.

There are no easy answers to the question of whether an individual should, or should not, make a Roth IRA conversion. Both tax and non-tax factors should be considered, as well as the account holder's individual circumstances. Some of the factors for and against conversion are set forth below.

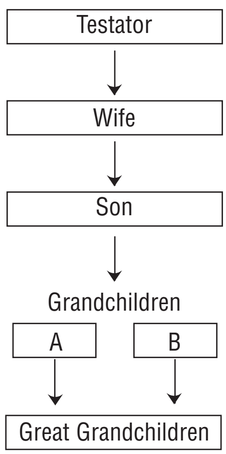
Factors Favoring Conversion	Factors Against Conversion
Have other sources for paying income taxes due from conversion.	Must use IRA proceeds to pay income taxes (possible early withdrawal penalty).
Will not need funds within the next 5 years.	Might need funds within 5 years (exposed to 10% early distribution penalty).
Expect to be in a *higher* income tax bracket during retirement years (e.g., believe tax rates will likely increase in the future).	Expect to be in a *lower* income tax bracket during retirement years (e.g., expect to have less taxable income in retirement).
Have many years before retirement – opportunity for tax-free buildup of interest, dividends, and capital gains.	Close to or in retirement – limited opportunity for tax-free buildup and distribution of earnings.
Large amount in traditional IRA will be forced out by RMD rules.	Need income from traditional IRA and not concerned about RMD rules.
Desire to leave tax-free income to heirs (i.e., Roth IRA is not taxed as IRD, see page 422).	Not particularly concerned about leaving tax-free income to heirs.
Payment of income taxes will reduce large estate and exposure to estate taxes.	Estate is not large enough to be exposed to federal estate taxes or state death taxes.
Live in state that has extended IRA bankruptcy protection to Roth IRA.	Live in state that has *not* extended IRA bankruptcy protection to Roth IRA.
Estate is large enough to be subject to estate taxes and prepayment of income taxes reduces taxable estate.	Estate is relatively small and assets are needed to provide income in retirement.

RULE AGAINST PERPETUITIES

This is a common law principle that no interest in property is good unless it must vest, if at all, not later than 21 years after some life or lives in being at the time of creation of the interest. The reason for this rule is to prevent an individual from unreasonably attempting to control from the grave the disposition of his estate by creating property interests in succeeding unborn generations. In some states, a wait-and-see rule would permit the trust to function until it became clear the rule was violated, as opposed to an immediate termination of all interests.

EXAMPLE A

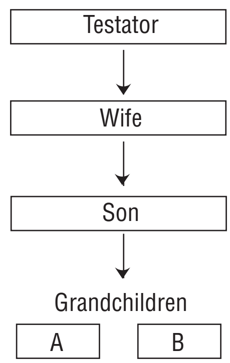
Testator leaves Blackacre to "my wife, W, for her lifetime, then to my son, S, for his lifetime, then to S's children who survive him for their lifetimes, and then in equal shares to such of my great grandchildren as are alive when the last of my son S's children dies."



The gift over to great grandchildren fails because it is not possible to know in whom the title ultimately vests until the last of the grandchildren dies, and it is possible that one or more of these great grandchildren would not have been born (in being) within 21 years of the testator's death.

EXAMPLE B

Testator leaves Blackacre to "my wife, W, for her lifetime, then to my son, S, for his lifetime, then in equal shares to such of my grandchildren as are alive when S dies."



This devise is good, since there are no circumstances under which the interest would fail to vest within the required period. The gift over to the grandchildren is good since it is limited to grandchildren who are alive when son dies, son being either a life in being at testator's death or the gift to the grandchildren will vest immediately.

In recent years, a growing number of states and the District of Columbia have modified or effectively eliminated the rule against perpetuities for trusts in those states. These jurisdictions have apparently made this change in order to encourage trust business in their states. Thus, it now appears that a trust may be established to last in perpetuity for the benefit of infinite future generations, provided the trust has sufficient connection with one of these states (as specified by state statute) to be governed by the state's trust law. Attention should be paid when "decanting" a trust (see page 370) either under the protection of specific statutory provisions or otherwise to consider the potential consequences of the jurisdiction's rule against perpetuities.

S CORPORATION

This is a corporation that elects to have its income taxed to its stockholders, rather than to the corporation. The manner of taxation is very similar to a partnership, in that it avoids the double taxation that can occur when dividends are paid by a regular C corporation. The following conditions must exist for subchapter S status to be effective:

1. It must be a domestic corporation.
2. It must not have more than 100 stockholders, none of whom is a non-resident alien (a husband and wife are considered one stockholder, and a family can elect to be treated as one stockholder).
3. Only individuals, certain trusts and estates, and certain charitable organizations and qualified retirement plans (but not corporations or partnerships) may own stock.
4. It can have only one class of stock outstanding (but there may be variations in voting rights).
5. A proper election must be made (all stockholders must consent).

S corporations offer the following advantages: (1) they are not subject to the corporate alternative minimum tax adjusted current earnings adjustment (see pages 363-365); (2) provided the S corporation has no earnings and profits, the attribution rules are not a problem (see pages 178-183); (3) there is no double taxation of earnings; (4) under some circumstances they will generate passive income which can offset passive activity losses from tax shelters; and (5) the individual income tax rates are generally lower than the corporate tax rates (see Federal Income Tax Rates, page 585).

The tax-favored employee benefits that can be received by stockholder-employees are quite restricted. Only those benefits received by stockholder-employees owning *two percent or less* of the S corporation's stock will be deductible as a business expense by the corporation (e.g., amounts paid for certain accident and health plans, and the cost of up to $50,000 group term life insurance). Stockholder-employees owning *more than two percent* of the stock are treated in the same manner as partners in a partnership and the cost of their benefits is generally not deductible to the corporation. However, they can take advantage of the rules covering health insurance premiums and medical expenses (see footnote 1, page 255).

Tracking of basis is very important with S corporations, since a stockholder's basis in his stock shields him from taxation when he receives distributions of income (or sells his stock).

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S CORPORATION (continued)

The higher the basis is, the higher is the untaxed distribution that can be received. A stockholder's basis increases when the corporation has income, either taxable or tax exempt. A stockholder's basis decreases: (1) when income is distributed; (2) when there is a loss; (3) when there is a nondeductible expenditure (e.g., a life insurance expense); and (4) when there is a capital distribution.

Example 1: How basis works - tax-free distribution of death benefit

A and B form S corporation, with A contributing $14,000 and B contributing $6,000. The corporation purchases a $500,000 term life insurance policy on key employee C. Ignore the Accumulated Adjustments Account (it is explained in Example 3).

Year 1: Corporate income of $35,000 and a $4,700 premium is paid for the $500,000 term insurance policy. Basis is increased for $35,000 of income taxed to stockholders, and reduced for the nondeductible $4,700 life insurance expense.

Year 2: Corporate income of $44,000 and a $5,100 premium is paid. Basis is increased for $44,000 of income taxed to stockholders and reduced for the nondeductible $5,100 life insurance expense.

Year 3: C dies and $500,000 death benefit is paid to corporation. Basis is increased for $37,000 of income taxed to stockholders and the $500,000 death benefit, which is tax-exempt income. Basis is decreased $500,000 for distributions to stockholders.

		Stock Basis			Accumulated Adjustments Account (AAA)
			A	B	
		Total	70% Owner	30% Owner	
Year 1:	Opening Basis	20,000	14,000	6,000	0
	Taxable Income	35,000	24,500	10,500	35,000
	Premium Expense	(4,700)	(3,290)	(1,410)	n/a
	Ending Basis	50,300	35,210	15,090	35,000
Year 2:	Opening Basis	50,300	35,210	15,090	35,000
	Taxable Income	44,000	30,800	13,200	44,000
	Premium Expense	(5,100)	(3,570)	(1,530)	n/a
	Ending Basis	89,200	62,440	26,760	79,000
Year 3:	Opening Basis	89,200	62,440	26,760	79,000
	Taxable Income	37,000	25,900	11,100	37,000
	Tax Exempt Income	500,000	350,000	150,000	n/a
	Total	626,200	438,340	187,860	116,000
	Distributions	(500,000)	(350,000)	(150,000)	
	Ending Basis	126,200	88,340	37,860	

Example 2: A reason to purchase permanent cash value insurance

Stockholder basis is not reduced for any expense "properly chargeable to capital account." The term "capital account" includes policy cash values. Therefore, with permanent insurance the basis reduction should be limited to the amount of the premium less the cash value increase (or cumulative premiums in excess of cumulative cash values). For example, if the $5,100 premium in year 2 of Example 1 was for permanent insurance, a cash value increase of $2,000 in that year would result in basis being reduced by only $3,100. A higher basis allows stockholders to receive increased tax-free distributions from the corporation.

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S CORPORATION (continued)

Example 3: Dealing with earnings and profits

If an S corporation has earnings and profits (E&P) it maintains an Accumulated Adjustments Account (AAA) in order to prevent double taxation of stockholders, while at the same time assuring that distributed E&P will be taxed as a dividend. This account increases when the corporation earns taxable income and decreases when the income is distributed to stockholders. Referring to Example 1, a distribution of the $500,000 death benefit with prior E&P of $100,000 would be taxed as follows (steps 1 and 3 reduce basis, whereas step 2 does not reduce basis):

			A	B
		Total	70% Owner	30% Owner
	Basis At End Of Year 3	626,200	438,340	187,860
1.	Tax-free (up to AAA)	116,000	81,200	34,800
2.	Taxable (up to E&P)	100,000	70,000	30,000
3.	Tax-free (up to basis)	284,000	198,800	85,200
	Total Distribution	500,000	350,000	150,000

Example 4: Avoiding a wasted increase of basis

Now assume that stockholder B was insured by the $500,000 term life policy for the purpose of funding a purchase of B's stock by the corporation. B dies on May 10th of Year 3 and the death proceeds are received by the corporation prior to the sale of B's stock to the corporation on June 11th. Allocating the $500,000 of tax exempt insurance proceeds and the $37,000 of taxable income using the normal "per share, per day" method recognizes that B owns 30 percent of the stock for only 161 days out of 365 days, or 44.11 percent of the year. Therefore, multiplying this 44.11 percent by his 30 percent of ownership results in allocating 13.23 percent of all income to his stock's basis, or a total of $71,045 (.1323 x 37,000 = 4,895; .1323 x 500,000 = 66,150; 4,895 + 66,150 = 71,045). However, allocating the full $71,045 to B's stock is considered a "wasting" of the allocation, because his stock already received a full step-up in basis as a result of his death (page 561).

			A	B
		Total	70% Owner	30% Owner
Year 3:	Opening Basis	89,200	62,440	26,760
	Taxable Income	37,000	32,105	4,895
	Tax Exempt Income	500,000	433,850	66,150
	Ending Basis	626,200	528,395	97,805

If the S corporation is a cash basis taxpayer, then an election can be made by *all* stockholders in their stock purchase agreement to terminate the taxable year whenever any stockholder terminates his interest in the corporation (e.g., by sale of all stock after death). This division of the taxable year into two short years is known as a "books and records" election. However, the redemption of stock must take place *prior* to the receipt of the insurance proceeds. Payment for B's stock could be made with a corporate note, which would be paid upon subsequent receipt of the death proceeds. This election would provide A with a basis increase equal to the full $500,000, which could be used to absorb subsequent tax-free distributions to A. The following assumes $20,000 of taxable income *before* the sale of B's stock and $17,000 of taxable income *after* the sale of B's stock:

			A	B
		Total	70% Owner	30% Owner
Year 3:	Opening Basis	89,200	62,440	26,760
	Taxable Income	37,000	31,000	6,000
	Tax Exempt Income	500,000	500,000	0
	Ending Basis	626,200	593,440	32,760

SAVINGS/THRIFT PLAN

Savings and thrift plans are defined contribution plans in which employee contributions generally make up a relatively large part of total contributions. Employer contributions typically equal a percentage of at least some part of the employee contributions. Although the Code makes no specific provision for these plans, they may be tax qualified provided they meet the requirements for a pension, profit sharing, or stock bonus plan. Frequently they qualify as profit sharing plans by providing for employer contributions out of current or accumulated profits.

These employer contributions to a profit sharing plan can be entirely discretionary, made according to a formula provision, or a combination of both. If on a discretionary basis, then the employer determines each year whether or not to make contributions to the plan (but a failure to make "recurring and substantial" contributions could result in disqualification of the plan). It is not necessary that the employer actually have current or accumulated profits. If on a formula basis, then contributions are made under a formula typically tied to employer profits (e.g., 5 percent of net profits after taxes, 10 percent of gross profits in excess of $100,000, or some other profit-driven formula). In either case, the employer can deduct up to 25 percent of total payroll of plan participants.

To encourage employee savings, the employer will typically match a portion or all of the employees' contributions. Although employee contributions are not deductible, employer-matching contributions are typically excludable from the employee's taxable income. Earnings on employee and employer contributions are not taxed to the employee until withdrawn.

Convenient payroll deduction of employee contributions, together with income tax deferral on employer contributions and tax deferred growth of both employee and employer contributions made these plans an attractive way to save money. At one time they enjoyed widespread use but have now been largely replaced by 401(k) plans offering the opportunity for before-tax employee contributions (see chart, page 269).

See also, the discussion of qualified retirement plans on page 519.

SECTION 72(t) CALCULATION

In addition to ordinary income taxes, taxable distributions from an IRA prior to age 59½ are generally subject to an early distribution penalty tax equal to 10 percent of the portion of the distribution that is includible in gross income. Upon reaching age 59½, an individual can withdraw any amount at any time without being subject to this penalty tax. A periodic payment exception allows penalty-free distributions prior to age 59½, provided they are part of a series of "substantially equal periodic payments," made at least annually, and lasting a specified duration. Payments made under this exception are referred to as "72(t) payouts."

The **duration requirement** is met if payments are made for the life or life expectancy of the individual or the joint lives or joint life expectancy of the individual and a designated beneficiary. Payments must continue for the longer of five years or until the individual has reached age 59½ (e.g., payments started at age 57½ must continue for five years to age 62½). Payment changes resulting from death or disability do not trigger penalties or interest. Three IRS-approved **calculation methods** are available for calculating penalty-free distributions prior to age 59½:

(1) **Required minimum distribution (RMD) method** is calculated by dividing the account balance by the individual life or joint life expectancy. The annual payment is recalculated each year and varies depending upon the account balance. A one-time change to the RMD method from either of the following methods is allowed.

(2) **Fixed amortization method** is calculated by amortizing the initial account balance over a specified number of years equal to life expectancy (single, uniform, or joint and last survivor) and an interest rate that is not more than 120 percent of the federal mid-term rate. The annual payment remains fixed in subsequent years.

(3) **Fixed annuitization method** is calculated using a mortality table provided by the IRS and an interest rate that is not more than 120 percent of the federal mid-term rate. The annual payment remains fixed in subsequent years.

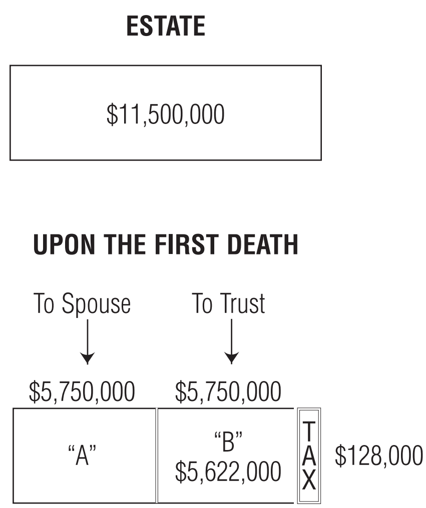
Comparison of IRA Early Payout Options
IRA Owner Age 50 – $100,000 Account Balance

Interest Rate	RMD Method	Fixed Amortization Method	Fixed Annuitization Method
2.5%	$2,151	$4,384	$4,524
3.5%	$2,151	$5,060	$5,255
4.5%	$2,151	$5,784	$6,029

Payouts shown are annual. RMD method shown uses uniform lifetime table. Fixed amortization method and fixed annuitization method shown are based upon a single life. See RMD tables in Appendix F of *Tax Facts On Insurance & Employee Benefits (2015)*.

SECTION 303 AND THE UNLIMITED MARITAL DEDUCTION

Under Section 303 of the Internal Revenue Code, the partial redemption, or sale, of stock may be made between the corporation and only that party having liability for the federal and state death taxes, funeral, and administrative expenses (see discussion, page 154). Because of this restriction, the utility of a Section 303 redemption to a surviving spouse is limited since no federal estate taxes will be paid if the marital deduction is fully used. For this reason, there may be some *advantage* to incurring a federal estate tax by passing more than the unified credit equivalent in stock to a surviving child, trust, or beneficiary other than the surviving spouse. This would not only allow full advantage to be taken of a redemption under Section 303, but would also avoid subsequent appreciation of the stock in the surviving spouse's estate. For an explanation of the unlimited marital deduction, see the chart entitled Trust Will, on page 25.



SECTION 306 STOCK

In a recapitalization, preferred stock issued as a dividend on outstanding common stock is generally considered Section 306 stock, to the extent that the issuing corporation has undistributed "earnings and profits." For this purpose, the term "earnings and profits" has a special meaning. Section 306 stock is said to be "tainted," in that a subsequent sale of the stock will produce ordinary income, not capital gain.

Upon the subsequent sale of Section 306 stock, such ordinary income treatment can cause adverse tax consequences beyond the loss of favorable capital gains treatment (see discussion, page 340). If the sale is a capital transaction, the seller can subtract his basis in calculating any gain subject to taxation. If the sale is of Section 306 stock, the amount realized is first treated as a withdrawal of earnings and profits and the seller could be taxed on the full amount received.

Even in a "true" recapitalization (i.e., an exchange of *all* of a stockholder's stock for a different class of stock), the problem of tainted Section 306 stock cannot be avoided if, at the time of the recapitalization, other family members are, and continue to be, stockholders. The family attribution rules (as set forth on pages 178-183) have been extended to apply to such "true" recapitalizations. However, this whole problem can be avoided if the stock is not sold until *after* the death of the stockholder. If the stock is then sold at a price representing the fair market value on the date of death (or on the optional valuation date), the "stepped-up basis" at death will eliminate any taxable gain. In this regard, see the discussion of Stepped-Up Basis on page 561.

SECTION 409A

Section 409A was passed by Congress to eliminate perceived abuses in deferred compensation arrangements (e.g., triggers in Enron's plan provided accelerated payments to senior executives, while lower-level employees were left with 401(k) accounts containing worthless company stock). Virtually every nonqualified deferred compensation plan is covered by the very broad provisions of Section 409A. Included are severance payments, bonus deferral arrangements, supplemental executive retirement plans (page 488), phantom stock plans (page 501), stock appreciation rights (page 501), and nonqualified stock options (page 491). Qualified plans are not covered (see page 519).

Election. Plan participants must elect to defer *before* the beginning of the year in which they earn the compensation. (First time participants may make the election within 30 days after becoming eligible, but only for services performed after the election.) On the deferral date, participants must make a one-time election as to how, and when, they want to be paid (e.g., annual payments for 10 years, beginning at age 60). Provided it is permitted by the plan, participants who desire to further delay receipt of the money for at least an additional five years, may make a re-deferral election no later than 12 months before the payment is due.

Distribution. Participants can receive distributions under only six circumstances: separation from service, death, disability, plan-specified date, unforeseeable emergency, and upon change in ownership or control of the corporation. However, full distributions are not required immediately upon occurrence of these events (e.g., permissible alternatives include "one year after change of control," or "in equal installments over five years after disability"). Certain key employees of publicly traded corporations may not take distributions until six months after separation from service.

Acceleration. Except under circumstances specified by the IRS, a nonqualified deferred compensation plan may not permit the acceleration of payments under the plan. These limited circumstances include distributions made to fulfill domestic relations orders, and distributions to comply with conflict-of-interest rules (i.e., situations that are unanticipated and nonelective). Triggers may not be used to protect assets from a change in the employer's financial health (e.g., acceleration if profits fall below a certain level).

Funding limitation. In addition to prohibiting triggers, plans may not set aside assets in an off-shore trust for the purposes of paying deferred compensation (but onshore Rabbi Trusts are not affected, see page 521).

Penalties. There are stiff penalties for failing to comply with 409A. Retroactive constructive receipt is imposed, with the money being taxed as of the time of the intended deferral. A 20 percent tax must be paid, in addition to the normal income tax, and interest is charged on the late payment at 1 percent higher than the normal underpayment rate.

SECTION 529 PLANS

Section 529 plans, also called qualified tuition programs (QTPs), are state-sponsored or privately-sponsored programs, authorized by federal law, that allow a taxpayer to: (1) purchase tuition credits or certificates on behalf of a designated beneficiary under a prepaid educational arrangement (PEA); or (2) make contributions to an educational savings account (ESA) established to fund the "qualified higher education expenses" (QHEEs) of a designated beneficiary. However, private colleges and universities may establish PEAs, but not ESAs. QHEEs include tuition, fees, special-needs services, room and board, and the costs of books, supplies, and equipment, required by a designated beneficiary at an eligible educational institution (post secondary education to include graduate school). There is a large difference among individual programs, many of which are more restrictive than required by Section 529. Before selecting a plan, the investor would be well advised to carefully review the individual account agreement and research the past performance of the underlying investment options.

Federal law generally does not place any limits on who may participate as an account owner, contributor, or designated beneficiary (except that the beneficiary must be an individual). In order to avoid excess contributions, they are typically limited to the amount necessary to provide five years of education at more expensive schools (e.g., some programs allow for contributions of up to $250,000). Contributions must be in cash, are not tax deductible, and are treated as completed gifts eligible for the gift tax annual exclusion ($14,000 in 2015). This gift tax treatment is unusual, given the owner's power to withdraw funds from the account – subject to penalties and taxes – or to designate a new beneficiary. Gifts in excess of the annual exclusion may be "front-loaded," meaning that a donor may avoid using available unified credit by treating the gift as made over a period of 5 years (for a maximum of $70,000 per spouse, or $140,000 per couple, to each designated beneficiary).

State-sponsored ESAs may permit the owner to choose among different investment strategies offered by the plan: (1) when the account is opened, (2) once every 12 months, and (3) whenever the beneficiary designation is changed. Certain age-based plans automatically move to more conservative investments as the beneficiary ages. Separate accounting must be maintained for each designated beneficiary, with no pledging of the account assets by either the owner or the beneficiary. However, the account can be attached by the creditors of the owner, but not by the creditors of the beneficiary. In contrast, the value of the account is included in the estate of the designated beneficiary.

All account earnings are tax deferred. Distributions used to pay QHEEs are excluded from gross income. Distributions not used for QHEEs are subject to a 10-percent-penalty tax on the taxable portion of the distribution.

SECULAR TRUST

The "secular" trust (as distinguished from a "rabbi" trust) is used to formally fund and secure nonqualified deferred compensation. Funds placed in a secular trust are not subject to the claims of the employer's creditors. So, unlike the rabbi trust (see page 521), the secular trust can protect employees from both an employer's future *unwillingness* to pay promised benefits and an employer's future *inability* to pay promised benefits due to bankruptcy or other financial difficulties.

However, the security offered by the secular trust comes at a price to the executive, because he is generally subject to current taxation. To offset the executive's current tax liability, the employer will sometimes pay a bonus to the executive. Current taxation of the executive is attractive to the employer because it provides the employer with a current tax deduction. Of course, as with any deferred compensation arrangement, all deferrals and bonuses must be reasonable compensation (see page 581).

There are two principal types of secular trusts: the employer-funded trust and the employee-funded trust. Because of its negative tax treatment, the employer-funded trust has lost popularity.

In an *employer*-funded secular trust, it is the Service's position that highly compensated employees will generally be taxed each year, not just on vested contributions to the trust, but also on any vested earnings of the trust. And because the Service further believes that employer-funded trusts cannot be employer-grantor trusts, the trust itself would also be taxed on this same income! Funding the secular trust with life insurance might avoid this double taxation by eliminating trust taxation: the cash value increases should be tax-deferred to the trust. Unfortunately, life insurance funding might not relieve the executive from taxation on trust earnings, because the Service appears to believe that these cash value increases would be currently taxed to highly compensated executives. It has generally been thought that distributions from employer-funded secular trusts will be taxed under the rules relating to annuities. But the Service has questioned the applicability of those rules to distributions to highly compensated employees from most employer-funded secular trusts.

In an *employee*-funded secular trust, either the employee contributes cash to the trust *or* the employer contributes cash to the trust after giving the employee a choice between receiving cash (or some cash equivalent) or a trust contribution. The employee is currently taxed on either the cash he actually receives and contributes to the trust, or on the employer contributions to the trust (he is considered to have constructively received the money). The employee-funded trust is generally considered an employee-grantor trust and its income is taxed to the employee only. Because the employee is fully taxed on both trust contributions and income, distributions from the trust should be free of income taxes.

SEE-THROUGH TRUST

Increasingly, IRAs are the major asset in many estates. Given the size of these accumulations effective estate planning involves the use of trusts to distribute proceeds and protect beneficiaries (e.g., to assure that IRA assets pass to beneficiaries chosen by IRA owner upon the death of a surviving spouse). However, unless the trust used qualifies as a "see-through" trust, it is not possible to fully maximize the benefits of income tax deferral for the IRA beneficiaries (the see-through trust is also referred to as a "look-through" trust).

The problem can be stated as follows: (1) distributions over the lifetime of the beneficiary, called "stretch distributions," may only be made to "designated beneficiaries"; (2) a trust cannot be a designated beneficiary, it has no life expectancy (only individuals may be "designated beneficiaries"); (3) an IRA with a nondesignated beneficiary must be distributed over a period of not less than 5 years; (4) if a trust is named beneficiary, then the IRA has no designated beneficiary and distributions must be made over a period of not less than 5 years. However, if a trust qualifies as a see-through trust, it is basically ignored and the individuals who are the trust beneficiaries are treated as the IRA beneficiaries.

The basic requirements for a see-through trust are: (1) the trust must be valid under state law; (2) the trust must be irrevocable, or become irrevocable upon the death of the IRA owner; (3) the trust beneficiaries must be identifiable from the trust instrument; and (4) relevant documentation must be provided to the IRA custodian in a timely manner (e.g. the current trust document). As beneficiary of an IRA, a see-through trust with multiple beneficiaries makes RMD withdrawals from an IRA account based upon the age of the oldest beneficiary of the trust (the older the age, the shorter the deferral period). This can be a problem when there is a substantial difference in age between the beneficiaries, as it will shorten the required distribution period for younger beneficiaries. For this purpose beneficiaries *include both residuary and contingent beneficiaries*.

To exclude both residuary and contingent beneficiaries from consideration, a "conduit" trust might be used (conduit trusts are also referred to as "flow-through" trusts). With a conduit trust the income beneficiaries are considered the sole beneficiaries and the ages of the residuary or contingent beneficiaries are not be considered in determining the age of the oldest designated beneficiary. To qualify as a conduit trust, the trustee must pay the RMD to the income beneficiaries as it is received from the IRA custodian. In contrast, the trustee of a see-through trust has the power to accumulate RMD for the benefit of trust beneficiaries.

For an expanded discussion, see **Q 3811**, *Tax Facts on Insurance & Employee Benefits (2015)*.

SELF-CANCELLING INSTALLMENT NOTES (SCINs)

A self-cancelling installment note (SCIN) is an installment debt obligation that by its terms is extinguished at the death of the seller-creditor. SCINs are also referred to as "death-terminating installment sales." Although a hybrid of the installment sale and private annuity, SCINs retain most of the tax advantages of the installment sale. For example, unlike a private annuity(see page 507), SCINs may be secured without jeopardizing their installment sale status and gain is generally deferred (see chart, page 43).

Under the typical installment sale, deferred gain is eventually recognized by either the seller or the seller's heirs. If the balance of the note is unpaid at death, the present value of future payments is includable in the seller's estate. Cancellation of the installment sale note at death does not avoid inclusion of the fair market value of the note in the seller's estate. When the seller and buyer are related, the fair market value of the note is considered to be no less than its full face value (i.e., the unpaid principal of the note).

With a SCIN, nothing will be included in the seller's gross estate (similar to a private annuity). Generally having gain reported in the decedent's tax return offers far more advantages than requiring the estate to report the gain, because the income taxes may then be claimed as a deduction for estate tax purposes. However, the Eighth Circuit has held that gain was to be recognized and reported by the seller's estate (Est. of Frane v. Commissioner, which overruled the Tax Court).

To properly establish a SCIN, the installments should be for a term shorter than the seller's life expectancy (this avoids characterization of the arrangement as a private annuity). In addition, the purchaser must pay a "risk premium" to the seller as consideration for the cancellation of the note at the seller's death. There is no specific statutory or regulatory guidance as to how this risk premium should be calculated. Apparently the premium can be reflected as an increase in the sales price, referred to as a SCIN-PRIN, or as an increase in the interest rate, referred to as a SCIN-INT. Despite these and other unresolved tax issues, the SCIN provides substantial flexibility in allocating income and deductions between seller and purchaser, while freezing the value of an asset through purchase by children or other family members. Under the right circumstances, the SCIN can be an attractive estate and income tax planning tool. The IRS has occasionally challenged SCINs on valuation issues, notably the value (as perceived by willing buyer/seller) of risks arising from the medical history of the seller.

In contrast to a SCIN, a private annuity for a term of years (PATY) is a private annuity for a (fixed) term of years or until the seller's death, whichever comes first. However, the SCIN can be secured and typically offers greater income tax benefits to the seller.

SELF-EMPLOYED RETIREMENT PLANS

There is a great variety of retirement plans available for the self-employed. The following generally lists them in the order of amount of maximum annual contribution, costs to set up, complexity, and difficulty of administration.

1. **Roth IRA.** In 2015 the maximum *nondeductible* contribution is limited to the lesser of 100 percent of compensation or $5,500, subject to a phaseout for taxpayers filing jointly with adjusted gross incomes between $183,000 and $193,000 (phaseout for single taxpayers is between $116,000 and $131,000). If age 50 or over catch-up provisions allow an additional $1,000 (for a total of $6,500). Husband and wife may each contribute $5,500 per year provided there is sufficient compensation. Early withdrawals of contributions are tax-free and penalty-free. Loans are not permitted. Generally low administrative fees and responsibilities. See page 535.
2. **SIMPLE IRA.** SIMPLE stands for Savings Incentive Match Plan for Employees. In 2015 the maximum *deductible* contribution is $12,500. If age 50 or over catch-up provisions allow an additional $3,000 (for a **total** of $~~15,000~~). The employer is required to either contribute 2 percent of the entire payroll or match contributions of up to 3 percent of each employee's salary. Early withdrawals prior to age 59½ are subject to a penalty. Loans are not permitted. Generally low administrative fees and responsibilities. See page 554. There are also SIMPLE 401(k) Plans (see page 308).
3. **SEP-IRA** – Also referred to as a **SEP** or **Simplified Employee Pension**. In ~~2014~~ the maximum contribution is limited to the lesser of $53,000 or 25 percent of the first $265,000 of net earned income (with sole proprietorships and partnerships, owners are effectively limited to 20 percent). There are no catch-up provisions. No minimum funding standards are imposed. Early withdrawals prior to age 59½ are subject to a penalty. Loans are not permitted. Generally easy to set up and administer. See page 555.
4. **Keogh Plan** – Also referred to as a **HR-10 Plan**. The typical Keogh Plan is designed as a defined contribution plan without a fixed contribution formula (in 2015 participants can contribute up to 100 percent of income to a maximum of $53,000). Plans may also be designed as a defined benefit plans (see below). Early withdrawals prior to age 59½ are subject to a penalty but loans are permitted. Administrative responsibilities and fees are high. Used in organizations consisting of ten or fewer highly paid employees. See page 295.
5. **Individual 401(k) Plan** – Also referred to as a **Solo 401(k) Plan.** In 2015 the maximum contribution is $53,000. If age 50 or over catch-up provisions allow an additional $6,000 (for a total of $59,000). No minimum funding standards are imposed. Early withdrawals prior to age 59½ are subject to a penalty but loans are permitted. Administrative responsibilities and fees are potentially high. See page 423.
6. **Defined Benefit Plan.** In 2015, depending upon age and projected income, the annual benefit at age 65 could be as high as $210,000. Nondiscrimination regulations restrict design for owner-employees of closely held businesses. Early withdrawals prior to age 59½ are subject to a penalty but loans are permitted. Administrative responsibilities and fees are high. See page 374.

SELF-SETTLED TRUST

When an individual (the settlor) creates an irrevocable trust for his or her own benefit, it is known as a "self-settled" trust. Generally, the benefit reserved by the settlor is to receive discretionary distributions from the trust. Self-settled trusts provide an independent trustee with full authority to make decisions as to how trust funds will be distributed.

If the trust also contains provisions that prevent creditors from reaching trust assets, the trust is known as a "domestic asset protection trust" (DAPT), "asset protection trust" (APT), or a "self-settled spendthrift trust." Although spendthrift provisions may have been originally intended to protect spendthrift beneficiaries from themselves, currently such provisions are most often used to protect settlor/beneficiaries from their own creditors (i.e., because the funds are not actually under the control of the beneficiary, the creditors of the beneficiary cannot reach the funds in the trust).

Historically, individuals were not able to create self-settled trusts that protected trust assets from the claims of their creditors. In the 1980s our increasingly litigious society encouraged individuals to turn for help to foreign jurisdictions. In order to attract trust business and capital, some countries had created anti-creditor and specially drafted trust laws that overrode long-standing rules against self-settled trusts. Sensing an opportunity, in the late 1990s Alaska adopted the first laws in the United States providing for self-settled spendthrift trusts. Colorado, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming have all adopted some version of DAPT legislation.

However, the laws of most states adhere to the long-standing rule that settlors cannot retain beneficiary rights in a trust, while at the same time protecting the trust assets from creditors. Given this environment, it is likely that the courts in these states will continue to issue judgments that provide creditors access to the assets in out-of-state trusts, despite spendthrift clauses (i.e., DAPT states must recognize other state's judgments under the Full Faith and Credit clause of the U.S. Constitution). Unfortunately, while there is a fair amount of state legislation, there is a paucity of case law pertaining to DAPTs. The effectiveness of self-settled trusts continues to be debated among highly respected members of the bar.

Another type of "self-settled" trust is actually a supplemental needs trust used to qualify or maintain a disabled individual's eligibility for Supplemental Security Income (SSI) or Medicaid (i.e., trust funds are not counted for eligibility purposes). These trusts are called "self-settled" because they are funded with the individual's own assets. They are also known as "payback," or "(d)(4)(A)" trusts (referring to the authorizing statute). The disabled individual must be under age 65, and the trust must be created by the disabled individual's parent, grandparent, guardian, or a court (the disabled individual cannot create his or her own trust, even if he or she is otherwise legally competent). At the beneficiary's death, funds remaining in the trust must be repaid to the state for Medicaid costs paid to or on behalf of the trust beneficiary.

See also, the discussion of asset protection on page 335, special needs planning on page 557, and trust protector on page 575.

SIMPLE CAFETERIA PLANS

SIMPLE cafeteria plans can be established by employers who have employed an average of 100 or fewer employees for either of the prior two years (the concept is similar to the SIMPLE 401(k) and SIMPLE-IRA). A small employer that establishes a plan and later exceeds the 100-employee limit may continue the plan until the year after a year in which it employs an average of 200 or more employees. When a plan qualifies as a SIMPLE cafeteria plan for any given year it is treated as meeting any applicable nondiscrimination requirements for that year (i.e., nondiscrimination testing is not required). In general, employer contributions are deductible, not subject to Social Security tax, and employee deferrals are not taxable income, so the available benefits can be purchased with pre-tax dollars. A SIMPLE cafeteria plan must satisfy certain eligibility and participation requirements.

Employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate. However, employees that may be excluded include those who: (1) have not attained age 21 before the end of the plan year (the plan may provide a younger age); (2) have less than one year of service as of any day during the plan year; (3) are covered under a collective bargaining agreement; or (4) are nonresident aliens. An employer may have a shorter age and service requirement but only if such shorter service or younger age applies to all employees.

A SIMPLE cafeteria plan must provide for employer nonelective contributions on behalf of every non-highly compensated and non-key employee. This requirement can be meet by contributing: (1) a uniform percentage of at least 2 percent of each qualified employee's compensation; or (2) at least the lesser of; (a) 6 percent of the qualified employee's compensation for the plan year; or (b) twice the amount of each employee's contribution. As noted above, these employer contributions are deductible, not subject to Social Security tax, and any employee deferrals are not taxable income. Highly compensated employees (per Code section 414(q)) and key employees (per Code section 416(i)) may participate, so long as they really are "employees" and do not receive disproportionate employer nonelective or matching contributions.

Available benefits may include health and dental insurance, reimbursement for health and dental expenses not covered by insurance, dependent care, group term life insurance, and disability insurance.

SIMPLE IRA PLANS

SIMPLE IRA plans ("SIMPLE" stands for Savings Incentive Match Plan for Employees) are easier to install and administer than a qualified plan. The SIMPLE IRA is considered a replacement for the SAR-SEP IRA and must be established by an employer for employees using either Form 5304-SIMPLE or Form 5305-SIMPLE.

In order to set up a SIMPLE IRA plan, the employer must not maintain another employer-sponsored retirement plan (including qualified plans, tax-sheltered annuities, and SEPs) and in the preceding year must have employed 100 or fewer employees earning at least $5,000. The plan must cover any employee who has earned at least $5,000 in any two preceding years and is reasonably expected to earn at least $5,000 in the current year. However, the employer may establish less restrictive eligibility requirements. Self-employed individuals may establish and participate in a SIMPLE IRA plan.

The employee is allowed to contribute up to $12,500 per year (in 2015). Although the deferral amount is expressed as a percentage of compensation, there is no limit on this percentage (e.g., in order to defer the maximum $12,500 per year, an employee earning $12,500 could elect to defer 100 percent of compensation). The $5,500 limit for traditional IRAs does not apply to a SIMPLE IRA. In addition, if the plan so provides, an individual age 50 or over may make catch-up contributions of up to $3,000 in 2014.

The employer is required to either contribute 2 percent of the entire payroll (under a nonelective contributions formula) or match contributions of up to 3 percent of each employee's salary (under a matching formula). However, a special rule permits the employer to elect a lower percentage under the matching formula, but not less than 1 percent, and it cannot be used for more than two out of any five years.

A SIMPLE IRA plan is not subject to nondiscrimination testing or top-heavy rules, and the reporting requirements are simplified. All contributions are excludable from the employee's income and must be fully vested. The penalty for early withdrawal prior to age 59½ is 25 percent during the first two years of participation and 10 percent thereafter (unless one of the exceptions applies).

A SIMPLE 401(k) plan is a 401(k) plan that satisfies the non-discrimination requirement by adopting certain SIMPLE 401(k) provisions that are similar to the above requirements. Such a plan is not subject to nondiscrimination tests and the top-heavy rules, but it will be subject to other qualified plan requirements. For details, see **Q 3715**, *Tax Facts on Insurance & Employee Benefits (2015)*.

SIMPLIFIED EMPLOYEE PENSION (SEP)

A simplified employee pension (SEP) is an employee's individual retirement account that may accept an expanded rate of contribution from his employer. Because payments are made into an IRA established for each employee, they are also referred to as SEP-IRAs. SEPs can be established with sole proprietorships, partnerships, or corporations, and are particularly attractive for the self-employed who has no employees or the individual who has additional income from outside employment. Generally, all employees must be included in a SEP except for: (1) employees who have not worked for the employer three out of the last five years; (2) employees who earn less than $600 (as indexed in 2015 for inflation); (3) employees who have not reached age 21; (4) employees covered by a collective bargaining agreement; and (5) non-resident aliens. They are generally easy to set up and require little administration.

SEPs can be established and funded as late as the due date (plus extensions) of the employer's (or self-employed's) tax return. In 2015 pre-tax contributions are limited to the lesser of $53,000 or 25 percent of the first $265,000 of net earned income (with sole proprietorships and partnerships the owners are effectively limited to 20 percent). No minimum funding standards are imposed. Contributions are not subject to income tax withholding, FICA or FUTA. Typically these plans are self-directed, in that the individual participant decides how funds will be invested. All earnings within the plan accumulate on a tax-deferred basis. The employer may not prohibit withdrawals from the plan, although they may be subject to a penalty tax if made before age 59½. Essentially, there are four types of SEP plans with varying degrees of complexity:

5305-SEP is very easy to implement, requiring only the completion of five questions on IRS Form 5305-SEP. However, this may not be used by employers who maintain other qualified retirement plans, use leased employees, or have had a defined benefit plan.

SEP prototype plans are provided by financial institutions (with or without a fee). Prototype plans are particularly useful if the employer wants to integrate the SEP contributions with Social Security (i.e., provide increased contributions for highly paid employees).

Individually designed plans are typically drafted by an attorney. They tend to be more expensive and complicated, therefore less often used.

SAR-SEP plans are salary reduction SEPs that allow employees to make pretax contributions to their IRAs. The provisions permitting the establishment of these plans were terminated at the end of 1996. SAR-SEPs already in existence prior to 1997 may continue to operate under preexisting law, receive contributions, and add new employees, but new SAR-SEPs may not be established. In their place, individuals may wish to consider the SIMPLE IRA (see discussion on page 554).

SOCIAL SECURITY - TAXATION OF BENEFITS

Under a two-tier system, up to 85 percent of Social Security benefits may be subject to income taxation. Under the **first tier**, if modified adjusted gross income (adjusted gross income plus tax-exempt income, or MAGI) plus one-half of Social Security income exceeds a base amount, an individual must include in gross income the *lesser* of: (1) 50 percent of the benefit; or (2) 50 percent of such excess over the base amount ($32,000 for married couples filing joint returns, zero for married couples filing separately who lived together during any portion of the year, and $25,000 for all other taxpayers). Under the **second tier**, if a taxpayer's MAGI plus one-half his Social Security benefit exceeds an "adjusted" base amount, he must include the *lesser* of: (1) 85 percent of the Social Security benefit, or (2) the sum of (a) 85 percent of such excess over the adjusted base amount, plus (b) the smaller of the amount includable under the first tier of taxation (see above), or $4,500 (single taxpayers) or $6,000 (married taxpayers filing jointly). The "adjusted" base amount is $44,000 for married couples filing joint returns, zero for married couples filing separately that lived together during any portion of the year, and $34,000 for all other taxpayers.

For example, the taxable benefit would equal $8,550 for a married couple filing jointly who had Social Security benefits of $14,000, adjusted gross income of $37,000 and tax-exempt interest of $3,000:

		The Lesser Of
85% of Social Security benefit (85% x $14,000)		$11,900
		or
Modified adjusted gross income	$40,000	
One-half the Social Security benefit	+ 7,000	
Total	47,000	
Adjusted base amount	(44,000)	
The excess multiplied by 85% ($3,000 x .85)	2,550	
Lesser of amount includable under first tier ($7,000) or $6,000	+ 6,000	
Sum of 85% of excess plus smaller of amount includable under first tier, or $6,000		$8,550

There is no longer any reduction in benefits once an individual reaches *normal retirement* age (i.e., earnings during and after the month the individual reaches normal retirement age will not reduce benefits). However, *early retirement* benefits will be reduced by: (1) $1.00 for every $2.00 of earnings over $15,120 during the years *before* reaching normal retirement age; and (2) $1.00 for every $3.00 of earnings over $40,080 during the calendar year before the month the individual reaches normal retirement age (e.g., there would be a reduction of $973 if an individual who reaches normal retirement age in April of 2015 had earned $43,000 in January thru March ($43,000 - $40,080 = $2,920 ÷ 3 = $973).

SPECIAL NEEDS PLANNING

Special needs planning involves providing for a physically or mentally disabled member of the family. Most often the disabled individual is a minor or adult child, but special needs planning also involves planning for dependent parents or other relatives. With a disabled adult child such planning should provide for him once his parents (the caregivers) become disabled or die. The ability of the disabled child to function will determine the required level and cost of care. Although caring for a person with a mental illness is generally considered more difficult and complicated than caring for a person with a developmental or physical disability, each situation is unique and must be planned for on an individual basis.

Even when other members of the family, such as siblings, are willing to assume the duties of caregiver, it is still important to provide for the management of assets. Either a testamentary or living trust can be used for these purposes (see chart on page 29). Such a trust, sometimes called a "supplemental needs trust," should: (1) appoint someone to take care of the child's property and money; (2) select a guardian for the child; (3) set out instructions on how the child is to be cared for; (4) ensure, to the extent possible, that the child will not lose payments or benefits from government agencies; and (5) integrate the trust with the remainder of the parent's estate plan. Survivorship life insurance on both parents would provide a cost-efficient means of funding this trust upon the deaths of both parents (see discussion, page 566). However, family dynamics should be considered when one or the other parent is the primary caregiver. Individual insurance on the primary care provider may be more appropriate when one parent provides most of the care. Disability income insurance on a working parent should also be considered.

At one time or another during his lifetime a disabled person could receive benefits from Social Security Disability Income (SSDI), Supplemental Security Income (SSI), Medicare and Medicaid. With a special needs trust the objective is to have the child's inheritance supplement, not replace, these government programs. See also, the discussion of the Self-Settled Trust on page 552.

Eligibility for government assistance can be negatively affected by the *disabled child's assets* (e.g., for purposes of the SSI benefit a single disabled person cannot own more than $2,000 in cash and liquid assets). Even when a trust consists of *third party assets*, if the discretionary powers of the trustee are not carefully limited, state laws may cause trust assets to be "available" to the beneficiary. However, under the federal Medicaid statute a trust established with the assets of a third party, such as a parent, is not considered "available" to the trust beneficiary.

Special needs planning may also affect other estate planning techniques. For example, under federal law a Medicaid recipient cannot refuse a gift. This means that a disabled child should not be given Crummey withdrawal powers, since his failure to make a withdrawal could jeopardize his Medicaid eligibility (see discussion, page 368).

Local laws governing special needs trust are in constant development, and recent state court cases have held that a trustee of such a trust may have an affirmative duty to determine the needs of a beneficiary with a disability, despite the grant of "discretion" by the trust provisions. Client's counsel should examine the relevant state statutes governing the conduct of such trustees, especially where the use of a lay trustee is contemplated.

SPLIT-DOLLAR ROLLOUT

This term refers to the termination of a split-dollar agreement when an employer-owned policy is transferred, or "rolled out," to the employee, or the cash values of an employee-owned policy are used to pay off the employer. The rollout can be at any time, but is usually timed to occur once the employee reaches normal retirement age.

As an insured grows older the endorsement and nonequity collateral assignment split-dollar plans taxed under the economic benefit regime can become very costly to maintain (see footnote 3, page 235). Likewise, the nondeductible loan interest due under an equity collateral assignment plan can become burdensome. When there is a permanent need for life insurance, such as to pay estate taxes, it is important to establish some means of maintaining the policy (often described as an "exit strategy").

Under a split-dollar plan taxed under the *loan regime* the employer is generally reimbursed for all cumulative premiums paid under the split-dollar agreement (i.e., employer releases assignment of cash values in employee-owned policy upon repayment of loans). Under a split-dollar plan taxed under the *economic benefit regime* when the employer-owned policy is transferred to the employee, or others (e.g., a trust), either the employer is paid for the policy or the employee is taxed on the value of the policy (as reasonable compensation). This value is determined without regard to surrender charges that would apply if the policy was terminated.

These exit strategies also include transferring the policy as a dividend distribution, distribution of the policy at capital gains rates in liquidation of the company, or funding purchase of the policy by a grantor trust using income from assets transferred into the trust at discounted values (see Intentionally Defective Trust chart, page 67).

Under the split-dollar regulations a "roll out" *without* taxation can occur as part of the transition to the two-regime taxation of split-dollar (see Equity Split-Dollar, pages 393-396). For plans entered into before January 28, 2002 there are two "safe harbor" provisions that protect employee-owned cash values (these safe harbors are further described in Table A on page 301):

1. The employee will not be taxed on cash values in excess of the employer's interest if the plan was terminated before January 1, 2004.

2. The employee will not be taxed on equity if the plan is converted to a loan from the employer to the employee for all periods beginning on or after January 1, 2004 (pre-2004 employer outlays considered beginning loan balance, and subsequent employer premiums added to loan balance).

SPOUSAL ACCESS TRUST (SLAT)

A Spousal Access Trust (also known as a Spousal Lifetime Access Trust or SLAT) is simply a type of irrevocable trust. These trusts are often funded with property which can include life insurance on the life of the grantor (non-beneficiary) spouse. With a Spousal Access Trust, unlike many traditional irrevocable trusts, *the grantor's spouse can be a beneficiary of the trust*. By permitting the spouse to be a trust beneficiary, flexibility is retained while still removing property (including life insurance proceeds) from the taxable estate of both spouses.

A Spousal Access Trust may be best explained by an example. Assume that Andy and Brenda are husband and wife. Andy creates a trust (as grantor) and names Brenda as Trustee. Brenda and their children are named permissible beneficiaries during the term of the trust and the children are the remainder beneficiaries upon termination of the trust. Brenda's rights to receive distributions during her lifetime are limited to needs for her health, education, maintenance, and support. At the death of Andy and Brenda, the trust will terminate and property will pass to their children. The Spousal Access Trust can be created in such a way as to be out of the estates of both Andy and Brenda.

Note that Brenda as the non-grantor (and non-insured spouse) can serve as the trustee of a Spousal Access Trust funded with a single life insurance policy on the grantor spouse (Andy) if the non-grantor spouse's (Brenda's) distribution rights are limited to the health, education, maintenance, and support ascertainable standard. If someone other than the non-grantor spouse (Brenda) is named as trustee, it may be possible to give the trustee greater flexibility over distributions. Neither spouse can be a trustee if a Spousal Access Trust is funded with a second-to-die life insurance policy, since the trust should not own a policy on the life of the trustee.

Because of today's relatively high income tax rates, cash value life insurance is an increasingly popular means of providing protection against early death while allowing accumulation of cash for lifetime needs. By utilizing a Spousal Access Trust, husband and wife (through the beneficiary spouse) can maintain access to the policy's cash surrender value (as well as any other property used to fund the trust) for such things as supplemental retirement and uninsured medical treatment. In contrast, with the less flexible irrevocable life insurance trust the insured's spouse does not have access to the cash surrender values. In community property states it is important to fund the Spousal Access Trust with separate property (i.e., do not fund with community property). If Spousal Access Trusts are created for each spouse the Reciprocal Trust Doctrine must be avoided (see discussion, page 524).

As with other irrevocable trusts, the advice of qualified counsel should be sought when considering a Spousal Access Trust.

STEP TRANSACTION DOCTRINE

In construing tax statutes, the step transaction doctrine requires that interrelated steps of an integrated transaction be taken as a whole rather then treated separately. The doctrine is used by both the IRS and the courts to link several prearranged steps or contemplated steps, even though there is no contractual obligation or financial compulsion to follow through. The following are examples of circumstances that could attract application of the doctrine:

1. Transfer by the insured of a life insurance policy on his life will cause the death proceeds to be included in the insured's estate if he dies within three years (see pages 405-406). In an attempt to avoid application of this three-year rule, a partner in a limited partnership contributes dollars to the partnership and these funds are subsequently used to purchase the policy from the partnership (a "sale" for adequate consideration is not considered a transfer for estate tax purposes, and is also an exception to the transfer for value rules, see pages 573-574). The step transaction doctrine might be applied to collapse the contribution-to-partnership and sale-to-partnership into one "nonsale" transfer of the insurance contract to the partnership.

2. Parent gives money to a child who then purchases an annuity naming the parent as the annuitant, and the child as both owner and beneficiary. If the child subsequently and consistently gives the annuity proceeds to the parent, the step transaction doctrine might be applied to collapse the parent-to-child and child-to-parent gifts.

3. Borrower places a second mortgage on his house and uses the funds to purchase a single premium annuity. Normally, interest paid on a second mortgage is deductible (within limitations). But no deduction is allowed for loans taken to purchase a single premium annuity. The step transaction doctrine could be applied to collapse the borrowing-on-mortgage and purchase-of-annuity transactions.

Related tax doctrines include: (1) the tax avoidance doctrine (transaction primarily intended to reduce taxes rather than to achieve nontax business or personal objectives); (2) the substance-over-form doctrine (transaction has minimal, if any, nontax consequences); and (3) the business purpose doctrine (transaction has no business purpose). It is suggested that one way of recognizing when a proposed transaction might run afoul of one or more of these doctrines, is to apply the "if it is too good to be true, it probably is" test.

STEPPED-UP BASIS

In Years 2001-2009, 2011 And Later

At death, the income tax basis of appreciated property in an estate is increased, or "stepped-up," to its fair market value as of the date of death. For this reason, when property is subsequently sold, there is no taxable gain if the sales price, or amount realized, is the same as the value on the date of death. However, when property has decreased in value, the basis will be "stepped-down" under the same rules as govern the determination of a step-up in basis.

The step-up in basis applies only to property that is included in the decedent's estate for federal estate tax purposes. This value can sometimes be influenced by the personal representative of the estate by filing an election to have the gross estate, including stock in a closely held corporation, valued on an alternate valuation date, usually six months after death. If this is done, the stepped-up basis equals the fair market value as of the alternate valuation date. Note, however, that use of the alternate valuation date is permitted only if its use would result in a reduction in the value of the gross estate and a reduction in the sum of the estate tax and generation-skipping transfer tax payable.

With property owned jointly between husband and wife, the stepped-up basis applies to only one-half of the property, since only one-half the value of such property is included in the estate of the first to die.

Special rules apply in order to prevent the transfer of property in anticipation of the donee's death. Therefore, there is no step-up in basis when property is acquired by a decedent (the donee) within one year of death and this same property is then at death passed back to the original donor or the donor's spouse.

In Year 2010

The 2010 Tax Relief Act repealed the modified carryover basis provisions of EGTRRA 2001 and restored the stepped-up basis. However, in the case of decedents dying after December 31, 2009, and before January 1, 2011, the excutor was given the option of electing back into a modified carryover basis. Electing back meant that the estate would not be subject to estate taxes, but would receive a limited step-up in basis. This is essentially a *carryover basis*, but modified to allow: (1) an aggregate step-up of $1,300,000; plus (2) a spousal step-up of $3,000,000 for assets passed to a surviving spouse; plus (3) the decedent's unused losses. To be entitled to the $3 million spousal step-up, the property must have been "qualified spousal property" (i.e., the interest could not be a terminable interest). See footnote 1, page 37. Not eligible for a step-up in basis were items considered to be income in respect of a decedent (IRD) and property received by the decedent within three years of death (except for certain gifts from the decedent's spouse). See page 422. In order to comply with this modified carryover basis system, detailed and onerous record keeping had to be maintained for virtually all assets.

STOCK BONUS PLAN

A qualified stock bonus plan is similar to a profit sharing plan (see page 512). However, in contrast to a profit sharing plan, the account values are often fully invested in the employer's stock. (A profit sharing plan may not invest more than 10 percent of its holdings in employer stock unless it meets the requirements for an "individual account plan.") Separate accounts are established for each participant and allocation of contributions and distributions of benefits are generally subject to the same requirements as a profit sharing plan.

Contributions are made either in cash (which is then used to purchase the stock of the employer) or in the stock of the employer. If made in stock, the amount of the employer's deduction for the contribution is determined by the fair market value of the stock when it is contributed. Unless the stock is publicly traded, some or all of the voting rights must be passed through to participants. Employer contributions are not fixed or required, may vary from year to year, and may or may not come from employer profits.

Distributions are generally in the form of employer stock, but a stock bonus plan may provide for payment of benefits in cash if certain conditions are met. [If employer securities are not readily tradable on an established market, the participant has a right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula. This is referred to as a "put option."] When stock is received in a lump sum distribution any net unrealized appreciation of the stock while held in the plan is not taxed until it is subsequently sold (i.e., taxation of gain is deferred). For example, assume a stock bonus plan purchased stock for $1,000 and it appreciated in value to $5,000. The stock is then distributed to a participant in a lump sum distribution, at which time the participant pays taxes on $1,000, but would not be currently taxed on the $4,000 of unrealized appreciation.

An employee stock ownership plan (ESOP) must meet the requirements for a stock bonus plan, as well as certain additional requirements (see pages 391-392).

See also, the discussion of qualified retirement plans on page 519.

STRANGER-ORIGINATED LIFE INSURANCE (STOLI)

Stranger-originated life insurance (STOLI), also known as investor-owned, investor-initiated and investor-originated life insurance, includes a variety of plans, or "schemes," to purchase large amounts of life insurance with the present intention of benefiting outside investors who have no independent insurable interest in the life of the insured. The board of directors of the American Council of Life Insurers has voted to support the creation of a federal excise tax on STOLI contracts settled in less than five years. New York state regulators have issued an opinion that STOLI policies created strictly for resale are contrary to law.

Charitable variation. This is a complex arrangement which seeks to utilize the insurable interests of a charity to provide investment gains to outside investors. A typical arrangement involves the establishment of a trust by a charity. The trust then borrows funds from outside investors with the promise that the investors will be paid a fixed income. These borrowed funds are used to purchase single premium immediate annuities on the lives of a select group of charitable donors (i.e., wealthy and older donors). Life insurance is purchased on these same individual donors – under state laws that give a trust created by a charity an insurable interest in a donor's life. The annuity income is used to pay the life insurance premiums and to make the fixed income payments to the investor group. As the life insurance death benefits are received, the investor group is repaid its investment and the charity receives any remaining proceeds.

Individual variation. A typical arrangement may involve an individual purchasing a life insurance policy on his life using funds from a nonrecourse loan obtained from outside investors. (If a nonrecourse loan is not repaid, the lender has no recourse against the borrower, only a right to seize the policy pledged as security.) Typically, after two years, the insured can choose to repay the loan with interest, sell the policy to a life settlement company, or transfer the policy to the lenders in full satisfaction of the loan. From their inception, these arrangements are structured in anticipation that the outside investors will take over ownership of the policy; it is not intended that the insured will retain the life insurance. In fact, these arrangements are marketed on one side to potential insureds as providing "free insurance" (albeit for only two years), and on the other side to "sophisticated" investors as a way of reaping enhanced returns on "portfolios" of life insurance policies.

There is something inherently disturbing about STOLI. These arrangements are suspect for many reasons: (1) the "renting" of an insurable interest to third-party investors is likely to be against public policy (see page 426); (2) investment returns are problematic (i.e., projections are dependent upon the timing of death proceeds from a small group of insureds); (3) participating charities are subjecting themselves to loss of their tax-exempt status; (4) large outstanding policies could negatively affect the insured's ability to obtain future life insurance coverage (see page 410); (5) such "rent-a-life" arrangements may subject "life settlements" initiated by policy owners to regulatory scrutiny (see page 462); (6) these arrangements often include misrepresentation and/or fraud pertaining to health or finances by the insured or the agent; and (7) turning life insurance into a commoditized investment could ultimately jeopardize its tax-favored status.

STRUCTURED SETTLEMENT

Structured settlements are used to provide long-term financial security in physical injury cases, by providing the injured party with periodic payments tailored to meet medical expenses and the needs of basic living. Whereas lump sum payments often result in the proceeds being poorly invested or squandered, structured settlements provide a stream of tax-free income from a reliable financial institution.

Situations appropriate for structured settlements involve: (1) wrongful death where a surviving spouse and/or children require ongoing income; (2) worker's compensation; (3) guardianship involving minors or incompetents; and (4) disabled or severely injured individuals.

To initiate a structured settlement, an agreement is reached between the plaintiff and the defendant regarding the benefits due to the injured party. This agreement can be reached before, during, or after a lawsuit. It may be agreed to privately, or it may be by order of the court (e.g., in situations involving the support of a minor child). Calculations on the costs of providing for the injured party's long-term needs are made by a structured settlement specialist, or structured settlement broker. There is great flexibility in designing the terms of a structured settlement. For example, periodic payments can be provided for a specific number of years, or made for the lifetime of the injured party with a guaranteed minimum number of years.

Once a settlement has been reached, the defendant, or its insurer, generally transfers the obligation to a financially secure and experienced life insurance company. This assignment relieves the defendant of any further obligation to make payments to the injured party. The life insurance company will typically use an immediate annuity to make the required payments. To assure that payments are received free of federal income taxes, the injured party, or annuitant, does not own the annuity contract; it is owned by the defendant, or its insurer.

Under Federal law the benefits under a structured settlement may not be assigned as collateral for a loan. However, in recent years there is a growing market involved in the purchase of existing structured settlements. In response, some states have enacted consumer protection statutes strictly regulating these transactions.

SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP)

A Supplemental Executive Retirement Plan (SERP) is an agreement between an employer and a selected key employee in which the employer agrees to provide a specified benefit at retirement, or upon termination, disability, or death prior to retirement.

SERPs are funded entirely by the employer with no contribution by the employee. In this sense, SERPs are unlike nonqualified deferred compensation plans in which the employee is, at least in theory, *deferring* compensation that otherwise could be taken currently (see chart, page 241). Unfortunately, SERPs are often described as "deferred" compensation agreements. In any case, SERPs are exactly what their name implies, they provide retirement benefits that *supplement* all other retirement plans such as IRAs, 401(k) plans, or qualified defined benefit pension plans.

The retirement benefits to be provided are generally determined using either a defined benefit or a defined contribution approach. A *defined benefit* agreement specifies an exact dollar amount to be paid (in a lump sum or otherwise) upon retirement, or upon termination, disability, or death prior to retirement. In recruiting high level executives, this type of SERP is often used to replace retirement benefits that will be forfeited when leaving another company. Rather than a fixed dollar amount, benefits under a defined benefit approach are more likely to be determined using a formula that considers the employee's years of service and pay (e.g., 70 percent of final 5 years average pay). When a *defined contribution* approach is used, individual accounts are established into which either discretionary or results-tied contributions are made based on company performance (e.g., 20 percent of salary if profitability exceeds a predetermined target). Vesting schedules are often used to provide for a graded benefit should the employee terminate employment prior to retirement.

Payments under the SERP are taxed as ordinary income to the employee in the year received and are deductible to the employer in the year paid. Should the employee die, payments to the surviving beneficiaries are also taxed as ordinary income (i.e., the life insurance death benefit is paid to the employer, not to the employee's beneficiary).

When life insurance is used to informally fund the employer's obligations under a SERP, the employer purchases cash value life insurance on the employee's life (see notice and consent requirements, page 358). The employer owns the policy, pays the premiums, and is the policy beneficiary. If the employee dies prior to retirement, the policy death benefit is payable to the employer. These funds can then be used to provide survivor benefits to the employee's beneficiary under the terms of the agreement. Upon the employee's retirement, the employer can use policy cash values to assist in meeting its obligations under the agreement, maintain the policy until the insured's death, or otherwise sell or dispose of the policy (see Transfer for Value, pages 573-574).

SURVIVORSHIP LIFE INSURANCE

Survivorship life insurance, also known as last-to-die insurance or second-to-die insurance, insures two lives, and pays a death benefit after the death of both insureds. Generally, the premium required is less than that for comparable insurance on either individual life, since the odds of two individuals dying during any given year are substantially less than of one individual dying.

While the many potential uses of survivorship life include charitable gifts (chart, page 55, and discussion, page 347), family income for surviving children (chart, page 15), key person insurance (chart, page 163), and funding installment sales within a family (chart, page 43); survivorship life is most often used to fund the payment of estate taxes, when the marital deduction defers taxes until the death of both spouses (chart, page 25). Survivorship life offers the advantage of simplicity by paying a death benefit exactly when taxes are due – upon the second death. With a rated or uninsurable client, coverage can usually be obtained, provided the spouse is insurable at standard rates.

There are some disadvantages to relying solely upon survivorship life insurance to fund the payment of estate taxes. For example, when the marital deduction is used to defer all estate taxes until the second death, appreciation of assets in the surviving spouse's estate can substantially increase total estate taxes. The flexibility provided by the use of disclaimers may be severely limited when there are no funds for payment of estate taxes at the first spouse's death (see discussion, page 380). After divorce the unlimited marital deduction is no longer available, unless the bulk of the estate is left to a new spouse.

Split-dollar is often used to pay premiums on a survivorship policy funding a life insurance trust (see Split-Dollar Funding Life Insurance Trust chart, page 233). The value of the gift to the trust can be substantially reduced by using the very low joint life rates that measure the probability of *two* deaths in one year. Although Table 38 has been used in the past for this purpose, this particular table may no longer be applicable (see discussion at the bottom of page 589). However measured, use of low joint life rates allows substantial coverage to be purchased within the "present interest" limits (see Gifts & Split-Gifts chart, page 47; and footnote 4, page 53). But it must be recognized that no death benefit will be paid until *both* insureds have died. This means that a survivorship policy must generally be funded for longer periods then a policy insuring just one individual. Also, after the first death, the value of the gift to the trust will be measured using higher single life rates (currently Table 2001, see page 588). This amount could exceed the $14,000 (as indexed in 2015) annual exclusion limit for present interest gifts.

TARGET BENEFIT PLAN

Under the target benefit plan, calculation of the employer's contribution takes into consideration not only the participant's compensation but also the participant's age when first entering the plan. By using age as a factor in allocating contributions employers are able to allocate more of their contributions towards older employees. In fact, when compared to a money purchase plan, a target benefit plan can substantially increase the annual contributions for older employees who have higher levels of compensation (see discussion of Money Purchase Pension Plan on page 484).

The target benefit plan is essentially a hybrid plan. Although the target benefit plan is a type of money purchase plan, it initially uses a defined benefit approach to determine a theoretical or "targeted" benefit that is expressed as a defined benefit formula (e.g., 50 percent of average compensation payable at a normal retirement age of 65). Actuarial assumptions involving investment rates of return and mortality are used to develop a table of contribution percentages (called a target benefit table) that is incorporated into the plan. A defined contribution approach is then used and the employer is required to make fixed annual contributions to the separate account of each participant according to the percentages contained in the target benefit table (the table typically sets the annual employer contribution as a percentage of compensation). Because the target benefit plan is a defined contribution plan, the annual additions are limited per participant to the lesser of 100 percent of compensation, or $53,000 (in 2015). Any increase in employee compensation will produce an additional benefit under the target benefit table (i.e., the increase in compensation produces a separate benefit that is funded with an additional annual contribution).

The employer does not guarantee the ultimate retirement benefit and the employee/participant bears the entire investment risk. If the earnings are lower than assumed, the actual benefit will be lower than the targeted benefit. Conversely, if the fund's earnings are greater than the actuary has assumed, the participant's actual benefit will be higher than the targeted benefit.

See also, the discussion of qualified retirement plans on page 519.

TAX-FREE EXCHANGE

Tax-free exchanges recognize that when property is exchanged by a taxpayer for "like kind" property, gain or loss need not be recognized and the transaction should not be subject to current taxation, since the taxpayer is in essentially the same position after the transaction as he was before the transaction. Under Section 1031 of the Code real estate transactions are frequently structured as tax-free exchanges.

Life insurance and annuity contracts can also benefit from the provisions for tax-free exchanges. These are often referred to as "Section 1035 exchanges" after the governing Code provision. In an exchange situation, life insurance policies are the most flexible, since they may be exchanged for another life insurance policy, an endowment contract or an annuity. Although an endowment contract cannot be exchanged for a life insurance policy, it can be exchanged for either an annuity or another endowment contract (provided the maturity date of the new contract is not later than the maturity date of the original contract). An annuity contract is the least flexible contract as it can be exchanged only for another annuity contract.

For purposes of a Section 1035 exchange, an endowment contract is considered a contract "which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life." The exchange of an endowment contract must be made *prior* to its maturity date.

In an exchange involving life policies, the policies must be on the life of the *same* insured and the new policy must be issued to the same person owning the old policy.

Tax-free exchanges can be particularly useful when it is desired to avoid taxation of cash values in excess of the policy owner's basis in the contract (net premiums paid, or generally total premiums paid less dividends, if any), or when it is desired to preserve the old contract's basis (substantial premiums have been paid in excess of available cash values). The old policy need not have been issued by the same company issuing the new policy. Some companies will accept assignment of policies containing an outstanding loan.

If there is a loan against the policy given in exchange, and no loan (or a lower loan) against the policy received in the exchange, the difference is treated as cash ("boot") received. The lesser of this amount or any gain in the policy given is taxable income. There is gain if total cash values, including loans, exceed total premiums paid, less dividends, if any. If there is no gain, then there is no tax (the amount simply reduces basis). Likewise, a withdrawal of policy values shortly before or after the exchange may be characterized by the IRS as a step transaction resulting in taxable boot. (See page 560.)

TAX LAW – SOURCES

Because many sources are cited as tax authority, it is important to understand the differences in the weight given them by the courts and their reliability as precedent. The citation at the end of each paragraph provides an example of how each source is cited.

Legislative and Administrative Sources

Internal Revenue Code. Congressional legislation that is the primary source of our federal tax law. [*IRC Sec. 417(a)(6)*]

Treasury Regulations. Amplify, supplement and interpret the Code. Given substantial weight by the courts and may generally be relied upon by taxpayers. Proposed regulations usually are not considered binding. [*Reg. §1.401(a)-20*]

Revenue Rulings. Issued by the National Office of the IRS. Although not as authoritative as regulations, they are given varying weight by the courts. Can generally be relied upon by taxpayers. Although revenue rulings can be revoked by the IRS, revocation is rarely retroactive. [*Rev. Rul. 72-25*]

Revenue Procedures. Reflect the internal management and state procedures the IRS will follow in specific situations. [*Rev. Proc. 95-3*]

Private Letter Rulings. Issued to a particular taxpayer by the National Office of the IRS. Although letter rulings are only uncertain indications of one line of reasoning by the Service and are not binding precedents, courts have considered them in reaching decisions. [*Let. Rul. 9212024*]

Technical Advice Memoranda. Issued to IRS personnel by the National Office of the IRS to assist with application of the Code, regulations and other precedents. Generally have the same effect as private letter rulings. [*TAM 9050006*]

Field Service Advice. Non-binding opinion written by IRS attorneys for internal use. Provides some insight into the thinking of the IRS at the time written. [*FSA 1998-252*]

Judicial Sources

Supreme Court. All courts follow Supreme Court decisions. The few tax cases it hears are accepted as a matter of discretion (certiorari). [*Gregory v. Helvering*, 293 U.S. 465 (1935)]

U.S. Courts of Appeals. Organized in thirteen circuits. Decisions of a court of appeals bind those lower courts within its appellate jurisdiction. [*Crummey v. Comm*., 397 F.2d 82 (9th Cir. 1968)]

Tax Court. The majority of tax cases are litigated in this court (it was formerly the Board of Tax Appeals). Taxes need not be paid before initiating a suit and there is no jury. Decisions reviewed by the entire Tax Court take precedence over unreviewed decisions (either regular or memorandum); unreviewed "regular" decisions take precedence over unreviewed "memorandum" decisions. The Tax Court has said that unreviewed memorandum decisions are not precedents, but this policy may be changing. Appeals (where available) are made to the appropriate U.S. court of appeals. Other federal courts and the Service are not bound by Tax Court decisions in future cases. [*Estate of Vandenhoeck*, 4 T.C. 125 (1944)]

Federal District Courts. Taxes must be paid before initiating suit, but a jury may be requested (jury decides facts, judge decides law). A district court is expected to follow its decisions, but its decisions do not bind other federal courts or the Service in future cases. Appeals are made to the appropriate U.S. court of appeals. [*Silberman v. U.S.*, 333 F. Supp. 1120 (W.D. Pa. 1971)]

U.S. Court of Federal Claims. Taxes must be paid before initiating suit and there is no jury. The court (previously, the U.S. Claims Court) is expected to follow its decisions, but does not bind other federal courts or the Service in future cases. Appeals are made to the Court of Appeals for the Federal Circuit. [*Arkla, Inc. v. U.S.*, 27 Fed. Cl. 226 (1992)]

TOP-HAT PLAN

A top-hat plan is an unfunded nonqualified deferred compensation plan established by an employer to benefit a select group of management or highly compensated employees. It is generally assumed that top-hat plans cover individuals who are in a position to negotiate for their own benefits and typically function as tax deferral devices rather than as an essential source of post-retirement income. Because of this such plans are generally exempt from ERISA's participation, funding, vesting, and fiduciary requirements (i.e., they are exempt from any meaningful regulation under ERISA). See the discussion of ERISA on page 399. Whether a particular plan is a top-hat plan, and thus exempt from ERISA, depends upon the facts and circumstances of each individual plan.

Although the term "top-hat" is not defined under ERISA, the exemption is available provided the plan is both (1) unfunded and (2) primarily for the purpose of providing deferred compensation for a select group of employees.

As with other nonqualified plans, determining compliance with the first requirement for a top-hat plan is relatively straightforward. To be *unfunded* plan benefits must be paid out of the employer's general assets and any vehicle used to informally fund the benefits must remain subject to the claims of the employer's general creditors.

Secondly, the plan must be maintained primarily for the purposes of providing deferred compensation to a *select group* of management or highly compensated employees. Satisfying the "purpose" requirement is typically not difficult given that the plan need only be maintained primarily, but not exclusively, for the purpose of providing deferred compensation. Satisfying the "select group" requirement can often be troublesome, since the Department of Labor has not provided definitive guidance regarding the term "select group."

The select group requirement includes both quantative elements and qualitative elements. For example, from a *quantitative* perspective a court has considered that a group constituting 18.7 percent of the total workforce of a company was too large to be select, whereas numerous other cases have determined that plans benefiting 10 percent or less of the workforce met the quantitative requirement to be a top-hat plan. To meet this requirement it is probably best to limit plans to 15 percent or less of the total work force. With respect to the *qualitative* elements, a select group must include either highly compensated or management-level employees. The "highly compensated" test is met provided there is a significant disparity between the average compensation of the top-hat group and the average compensation of all other employees. To be considered a "management-level employee" requires that the employer have established a basis for designating the employee as performing management functions. The mere fact that the employer considers the employee "key" does not meet this requirement.

TOTAL RETURN UNITRUST

The total return unitrust is an attempt to reconcile the conflicting interests of the income and remainder beneficiaries by allowing the trustee to invest trust assets for total return (i.e., for capital appreciation as well as income).

The traditional "income and principal" trust directs that the trustee pay all trust income to the income beneficiary, with corpus distributed to the remainder beneficiaries upon the death of the income beneficiary (e.g., "income to my wife for life, then payment of the corpus in equal shares to my children"). In order to provide for the income beneficiary, trust assets were typically invested in fixed *income* investments (e.g., bonds). However, failing to take advantage of strong stock market performance creates disgruntled *remainder beneficiaries* (e.g., the children). To remedy this situation, a majority of states have enacted some form of the prudent investor rule (see discussion, page 513). Under this rule, trustees can utilize modern portfolio theory and invest for capital appreciation in a diversified portfolio of equity and growth stocks. However, foregoing trust income in order to attain greater trust appreciation creates disgruntled *income beneficiaries* (e.g., surviving spouses).

Caught in the middle is the trustee – who has a duty of fairness to both the income and remainder beneficiaries. The "total return unitrust" is an attempt to balance the competing interests of the income and remainder beneficiaries while obtaining greater trust appreciation.

Rather than focusing on income producing investments, under the "total return" approach a trustee, governed by the prudent investor rules, can invest in equities in order to obtain greater long-term growth of trust assets. With a "total return unitrust," the trustee is required to pay out a fixed percentage of the fair market value of the trust assets each year; thereby *enabling the income beneficiary to enjoy the benefits of trust appreciation*. A "smoothing" formula is used to cushion rapid year-to-year changes in trust value (e.g., using a 3-year rolling average to determine fair market value).

The IRS has issued regulations intended to accommodate state law changes to the concepts of income and principal. Under the regulations, allocations between income and principal will be respected by the Service if state law provides for a "reasonable apportionment" between the income and remainder beneficiaries of the total return of the trust, to include ordinary income, capital gains, and unrealized appreciation (e.g., a unitrust amount of three to five percent would be considered reasonable).

Transfers in trust avoid current gift and estate taxes provided a spouse, as income beneficiary, is entitled to all trust income for life (i.e., the trust qualifies for the unlimited marital deduction, as in the "A" trust on page 25). Under the proposed regulations, this "all income to spouse" requirement is met – and the marital deduction is preserved – when a unitrust makes such a "reasonable apportionment" of the total return of the trust.

TRADITIONAL IRA

This is another name for the original (regular) individual retirement arrangement that was first made available in 1974 under the Employee Retirement Income Security Act (ERISA). Under this Act, the primary purpose of the Individual Retirement Account, or IRA, was to give those individuals not covered by an employer's retirement plan the opportunity to save for retirement on their own by establishing tax-deferred accounts with private financial institutions. Additionally, the IRA was also intended to provide a place for transferring, or rolling over, balances from employer-sponsored retirement plans; thus giving both retiring workers and individuals who were changing jobs a way to preserve their employer-sponsored retirement plan assets.

In Publication 590 (Individual Retirement Arrangements (IRAs)), the Internal Revenue Service defines a traditional IRA as "any IRA that is not a Roth IRA or a SIMPLE IRA" (i.e., the term is used to distinguish the original IRA from the Roth IRA and the SIMPLE IRA). See the expanded discussion of the traditional IRA on page 424.

In contrast to the traditional IRA, the SIMPLE IRA must be established for employees by an employer. It is not limited to the traditional IRAs $5,500 per year contribution limit. In 2015, with a SIMPLE IRA an employee may contribute up to $12,500 per year, plus age 50 and over catch-up contributions. See the expanded discussion of the SIMPLE IRA on page 554.

Likewise, in contrast to the traditional IRA, the Roth IRA permits an individual to make *non-deductible* contributions to a tax-deferred account up to the same dollar limits. Provided certain requirements are met, distributions from the Roth IRA are not subject to income taxes. See the expanded discussion of the Roth IRA on page 535.

TRANSFER FOR VALUE

The transfer for value of a life insurance contract jeopardizes the income tax-free payment of its proceeds. Under the transfer for value rule, if a policy is transferred for a valuable consideration, the death proceeds will be taxable as ordinary income, except to the extent of the consideration, the net premiums and certain other amounts paid by the transferee.

The transfer for value rules extend far beyond outright sales of policies (see **Q 265**, *Tax Facts on Insurance & Employee Benefits (2015)*). The naming of a beneficiary in exchange for any kind of valuable consideration would constitute a transfer for value. Consideration does not have to be in money, but could be an exchange of policies or a promise to perform some act or service. However, the mere pledging or assignment of a policy as collateral security is not a transfer for value.

Specific *exceptions* to this rule allow a transfer for consideration to be made to the following, without jeopardizing the income tax-free nature of the death benefit:

1. Transfers to the insured.
2. Transfers to a partner of the insured.
3. Transfers to a partnership in which the insured is a partner.
4. Transfers to a corporation in which the insured is a stockholder or officer (but there is no exception for transfer to a co-stockholder).
5. Transfers between corporations in a tax-free reorganization if certain conditions exist.

A *bona fide gift* is not considered to be a transfer for value and subsequent payment of the proceeds to the grantee (donee) will be income tax-free. (Part sale/part gift transactions are also protected under the so-called "transferor's basis exception" that provides that the transfer for value rule does not apply where the transferee's basis in the policy is determined in whole or in part by reference to its basis in the hands of the transferor.)

The transfer for value problem does not exist with a partnership, because a transfer to a partner of the insured is one of the exceptions to the rule. Thus, it is possible to convert from an entity purchase agreement to a cross purchase agreement and use the same policies to fund the new agreement.

With respect to a corporation, once a stock redemption agreement (i.e., entity purchase agreement) has been funded with life insurance, it is *not* possible to change to a cross purchase agreement and use the *same* policies to fund the new agreement. Transfer by the corporation of an existing policy on the life of one stockholder to another stockholder would be a violation of the transfer for value rule (but transfer to a partner or a bona fide partnership of which the stockholder was a partner would fall within exceptions to the transfer for value rule). However, this problem does not exist in changing from a cross purchase agreement to a stock redemption agreement: the transfer to a corporation in which the insured is a stockholder is an exception to the rule (see 4 above).

(continued on next page)

TRANSFER FOR VALUE (continued)

Some planners have suggested the use of a trusteed cross purchase agreement to avoid a problem of multiple policies when there are more than just 2 or 3 stockholders. Under this arrangement, a trustee would be both owner and beneficiary of just one policy on each of the stockholders. However, it is likely that there is a prohibited transfer for value when one of the stockholders dies and the surviving stockholders then receive a greater proportional interest in the outstanding policies that continue to insure the survivors.

For example, assume A, B, C and D are equal stockholders in a corporation with a funded trusteed cross purchase agreement. Under the arrangement each stockholder is the beneficial owner of a one-third interest in the policies insuring the other three stockholders. Now assume D dies. A prohibited transfer for value could occur if D's proportional interests in the outstanding policies insuring A, B and C pass to the surviving stockholders upon D's death. However, the problem can be avoided by having the corporation purchase D's interests in the policies insuring A, B and C, with the intention of funding a combined cross purchase and entity purchase agreement (see chart entitled, "Wait And See" Buy/Sell Agreement, on page 147). Alternatively, the problem could also be avoided by simply using a stock redemption agreement, as shown in Entity Purchase Agreement chart on page 131. See page 138, for an expanded discussion of the Trusteed Cross Purchase Agreement.

The transfer-for-value rule does not apply to the transfer of a life insurance policy to a grantor trust, when the policy insures the life of the grantor of the trust (e.g. the policy is sold to the trust). For tax purposes the trust and the insured grantor are one and the same, and thus the sale is considered a transfer to the insured. See Grantor Trust Rules on page 414.

Transfer for value problems can occur in rather unexpected circumstances. For example, the transfer of existing life insurance policies insuring stockholders to the trustee of a trusteed cross purchase agreement does not fall within one of the exceptions to the transfer for value rule. To avoid this initial ownership problem the trustee should be the original applicant, owner and beneficiary of the policies.

A prohibited transfer for value can also occur when a split-dollar agreement involving a trustee is terminated pursuant to a "rollout" (see page 558). When the agreement is between the employer and the trustee of an irrevocable trust, using endorsement split-dollar with the policy owned by the employer would require a transfer of the policy to a trustee who does not fall within any of the exceptions to the transfer for value rules. However, using collateral assignment split-dollar established under the "loan regime" will avoid this transfer for value problem. See the discussion of Equity Split-Dollar on pages 393-396.

TRUST PROTECTOR

The concept of a "trust protector" owes its origin to the foreign (offshore) asset protection trust (see page 335). In an effort to protect assets from the claims of creditors, the grantor of a foreign asset protection trust will typically transfer substantial amounts of property to a trust that cannot be directly amended or revoked by the grantor. Using a trusted party to act as the trust protector gives the grantor a degree of *influence over*, or even de facto control of, the foreign trust. (Some asset protection trusts name the grantor as the initial trust protector, but the grantor *should not* be named the trust protector of a domestic trust.)

With a domestic trust, such as an irrevocable life insurance trust (chart, page 51), utilization of a trust protector provides a means of *monitoring* the trustee's performance in order to assure that the grantor's original intentions are carried out. Additionally, the trust protector provides *flexibility* in adapting the trust to changing family circumstances and evolving tax laws.

The trust protector powers are ordinarily *limited* to: (1) correct any drafting errors in the original trust instrument; (2) modify or amend the trust instrument to achieve favorable tax status, or to adjust to changes in the Internal Revenue Code, state laws, rulings, and regulations; (3) remove or replace the trustee; (4) increase or decrease the interests of trust beneficiaries (e.g., limiting a beneficiary's right of withdrawal or power of appointment); (5) appoint trust assets to another trust created by the same grantor; (6) regulate trust investments; and (7) change the situs of the trust (if possible under state law).

The trust protector is often someone whom the grantor knows and has confidence in, such as a close family friend or a professional advisor. It is important that this person be independent of both the trustee and the beneficiaries. Therefore, the trust protector should not be the grantor, the spouse of the grantor, a person who has either a present or future beneficial interest in either the trust income or principal, a person who has ever made a transfer to the trust, or the spouse of any such person.

With domestic trusts, use of a trust protector is a relatively new practice. Although there is currently little, if any, case law and legislative direction relative to the functioning of a domestic trust protector, the concept appears sound and can be expected to gain in acceptance.

TRUSTS FOR MINORS

In order for a gift to qualify for the annual exclusion, the donee must have the right to immediate use and enjoyment of the property (chart, page 47). As a matter of principle, many donors will object to placing title to property in the name of a minor, and it can create problems in dealing with the property. Fortunately, for those who intend to make substantial gifts over a number of years, the Code authorizes two types of trusts that can be used to obtain the annual exclusion:

Section 2503(c) Trust. Under this trust, both income and principal may be expended by or on behalf of the beneficiary prior to age 21, and the unexpended income and principal *must* be paid to the beneficiary upon attaining age 21 or sooner. If the minor beneficiary dies before age 21, the trust corpus passes to the minor's estate or is subject to a general power of appointment by the minor. It is permissible for the trustee to purchase life insurance on the minor's life and pay premiums from trust income (if the trust authorizes purchase of insurance on the grantor's life, or on the life of the grantor's spouse, there will be a violation of the grantor trust rules, and all income will be taxable to the grantor). Distributed income is taxable to the minor, and accumulated income is taxable to the trust. The donor should not be named trustee, as that will cause the trust assets to be included in his estate if he dies prior to the minor's reaching age 21.

Section 2503(b) Trust. This trust should be considered by the donor who does not want trust corpus and unexpended income to be distributed at age 21 or sooner. The principal can be paid to the beneficiary at whatever dates or times are established by the donor, and need not ever be paid to the beneficiary, but rather paid to another person specified by the donor or the trust beneficiary. However, such a trust must provide for a *mandatory distribution of income* to the beneficiary, at least annually, or more frequently (but could be deposited to a custodial account). Making the gift requires a calculation that involves dividing the gift into an income portion (that which qualifies for the annual exclusion) and a principal or remainder portion (that which is considered a gift of a future interest).

Because establishment of both types of trusts can be expensive and time consuming, many donors may find it more convenient to make gifts under the Uniform Transfers to Minors Act or the Uniform Gifts to Minors Act (page 580).

UNDERWRITING: MARIJUANA AND e-CIGARETTES

An increasingly discussed area in life insurance circles is the manner in which marijuana and e-cigarettes are addressed by life insurance carriers. There are ramifications for both relative to medical underwriting and there are financial underwriting issues surrounding marijuana.

Background

E-cigarettes are plastic and metal devices that heat a liquid nicotine solution in a disposable cartridge creating vapor that the user inhales. Surprisingly, the first e-cigarette was patented as early as 1963, but it only became popular after a 2003 patent.[1] Tobacco use remains high. Although it has dropped significantly in the US since the 1964 Surgeon's General Report (a drop among adults from 43 percent in 1965 to 19 percent in 2014) usage remains high. Nearly 50 million Americans still use some form of tobacco with 443,000 smoking attributed death each year (10 percent attributed to second hand smoke). Worldwide there is an estimated 1.2 billion tobacco users with 6 million tobacco-related deaths annually. E-cigarette usage is only a small fraction of sales compared to traditional cigarettes (about 20 percent have tried e-cigarettes). Sales approached $2 billion in the US in 2013, but are forecast to rise to $10 billion in the next several years.

There are significant differences between traditional tobacco and e-cigarettes. There are over 7,000 know toxins and carcinogens in tobacco. By contrast, the toxic substances in e-cigarettes are lower. An analysis of 12 different types of e-cigarettes show toxic substances at levels 9 to 450 times lower; nicotine concentrations range from 7.4 to > 18mg/e-cig cartridge.[2] Still, there is no long term analysis of the effects of e-cigarettes. Nor is there any regulation or oversight of their manufacture; and no guidelines relative to sterile manufacturing. There are currently (2014) over 200 manufacturers each using widely different standards. Currently only e-cigarettes that are marketed for therapeutic purposes are regulated by the Food & Drug Administration (FDA). However, the FDA is expected to treat e-cigarettes akin to tobacco.

Marijuana is the most common illicit drug used in the United States accounting for over 75 percent of all current illicit drug use. In the US, about 5 million use it frequently (at least 51 days per year). The Federal government considers marijuana a Schedule I substance (having no medicinal uses and high risk for abuse). That aside, two states have legalized marijuana for adult recreational use and 21 states have passed laws allowing its use as a treatment for certain medical conditions. Among the possible benefits are autoimmune disease (inflammation and pain), seizures and substance abuse). These continue to be tested in National Institute for Health (NIH) studies.

(continued on next page)

UNDERWRITING: MARIJUANA AND e-CIGARETTES (continued)

Medical Underwriting

From a medical perspective, e-Cigarettes have not been fully studied so consumers and insurers currently don't know the potential risks of e-cigarettes when used as intended and how much nicotine or other potentially harmful chemicals are being inhaled during use. Although the harmful effects of traditional cigarette smoking lies in the tobacco leaf and other chemicals, most carriers have limits on both cigarette smoking and tobacco in any other form, such as chew.

For many carriers e-cigarette use falls into the "other form of tobacco product." Typically nicotine is detected through tests of a proposed insured's urine. If the nicotine content in urine is negative then a no-tobacco rating is often available. However, If the nicotine is present in one's urine (positive) the some form of tobacco rates will usually be offered. It will be difficult for an underwriter to determine if an individual is using e-cigarettes or traditional tobacco products. As such, from a medical underwriting perspective there is little advantage to use e-cigarettes.

There is some speculation that in the future carriers may be able to offer rates for e-cigarette use that would be better than tobacco use rates, but higher than no-tobacco use rates.[3] However, that is likely to be some years away, requiring long-term controlled studies of e-cigarette users compared to control populations.

Unlike e-cigarettes, for marijuana there is a wide understanding of its medical underwriting implications. Marijuana contains a number of Tetrahydrocannabinol (THC) like intoxicants that are immediately taken up by fat cells, stored and then released slowly over time. THC may be detectable anywhere from 3 days to a month later. By contrast, alcohol contains only one intoxicant, ethanol, that is not stored in the body and is metabolized in a linear, predictable, fashion. As a result, there is no reliable method to quantify marijuana impairment, although plasma levels are being tested in Colorado. It's worth noting that THC levels in marijuana today are close to 15 percent (compared to 4 percent in the 1980s).

From a medical underwriting standpoint it is difficult to distinguish between inhaled and ingested forms. As a result, both forms are generally treated the same for underwriting purposes. Among the concerns associated with marijuana use are 1) altered perceptions and mood, 2) ~~impaired and~~ difficulty with thinking and problem solving, 3) impaired motor skills and 4) when used heavily by young people its effects on cognitive skills and memory may be long-term or permanent as well as having an addiction potential. Related to mental impairment judgment and motor coordination is the increased risk of injury and death while driving. Chronic marijuana use is also linked to mental illness. Additionally, marijuana users have an increased risk of heart attack in the first hour after taking the drug. In its inhaled form, marijuana remains an irritant to the lungs, can have many of the same respiratory effects as experienced by tobacco smokers. Use in pregnancy can trigger issues in fetal neurological development as well as post-partum neurological issues.

As far as underwriting, most carriers will treat marijuana the same for both illicit and prescription use. Most will treat users as some form of smoker rate (because of the inability to distinguish between ingested and inhaled forms. For many carriers marijuana ~~that is~~ less than once per month should be able to obtain a smoker rate, possible preferred. As use increases to 2 joints per week the underwriting category may be reduced to Standard smoker. At more than 2 per week that rate may slide to mild substandard rate.

Financial Underwriting Considerations

Financial Underwriting where marijuana is involved can be problematic. Because marijuana remains a controlled substance under Federal law, transacting business involving marijuana is considered illegal. In June 2011, the U.S. Department of Justice issued a memo conveying the consequences of those individuals caught cultivating, selling or distributing marijuana, and those who engage in transactions involving the proceeds of such activity may also be in violation of federal money laundering statutes and other federal financial laws. Subsequently, most financial institutions have chosen to deny access to financial services for marijuana dispensaries. As a result, ~~man~~ legal marijuana dispensary businesses are often conducted as cash-based business as they have difficulty opening and/or maintaining bank and investment accounts. Similarly, American Express, MasterCard and Visa have all opted not to accept credit cards for the payment of marijuana purchases. This topic is currently under discussion with the Department of the Treasury, Department of Justice and various financial regulators. It is anticipated that official government guidance will be rendered on this topic in the future.

This presents a current dilemma relative to financial underwriting any business or individuals involved in transacting marijuana related businesses. It becomes difficult to determine what assets an entity or individual in these activities hold, even if legal at the state level. Some carriers will not consider cases involving marijuana and others will reconsider cases in the event facts involving the marijuana trade become known after policy issue.[1]

1 Many of the statistics quoted here are from a presentation, Vapor and Herb in the Breeze, by Dr. Bruce Hendricks on March 29, 2014 at the Risk Appraisal Forum.

2 The highest concentrations approach the same concentration as a nicotine patch.

3 Ibid, note one.

UNIFORM TRANSFERS/UNIFORM GIFTS TO MINORS ACTS

Gifts can be made to a minor by transferring property to a custodian under the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). Because the UGMA places restrictions on the types of property that can be the subject of a custodial gift, most states have now adopted the UTMA. It appears that life insurance policies may be the subject of a gift in all states. However, in most states there are restrictions on who may be named insured; there may also be restrictions on who may be named beneficiary (see discussion of Minors and Life Insurance, page 483).

Gifts made under either act can qualify for the annual exclusion (see chart, page 47). All income from the gift will be taxable to the minor (unless it is used to discharge the legal obligation of another person, in which case the income would be taxable to that person). Unlike a minor's trust, the custodian does not file a separate tax return and all income is reported by the minor on his own tax return. The minor has the right to receive possession of the property upon attaining the age specified in the relevant state's statute (age varies from state to state, and may depend upon the instructions of the donor or the nature of the transaction that created the custodianship).

If the donor appoints himself as custodian, the property will be included in his taxable estate if he dies while serving as custodian. There can be only one beneficiary per custodial account, and therefore separate accounts must be established for multiple beneficiaries. Likewise, each account can only have one custodian and successor custodians are usually the minor's guardians.

In 2015 the unearned income of a child that exceeds $2,100 generally is taxed to the child at the *parent's* maximum rate (known as the "kiddie tax"). For this purpose a child is considered an individual who is: (1) under age 18; (2) under age 19 whose earned income does not exceed half of his or her own support; or (3) under age 24, if a full-time student, whose earned income does not exceed half of his or her own support.

However, in 2015 a parent can elect to claim the unearned income of a child on the parent's return if: (1) the child's income is solely from interest and dividends; and (2) the income is more than $1,050 but less than $10,500; and (3) there has been no backup withholding or estimated tax payments under the child's taxpayer identification number. For this purpose the child must be either: (1) under age 18; (2) under age 19 whose earned income does not exceed half of his or her own support; or (3) under age 24, if a full-time student, whose earned income does not exceed half of his or her own support. If the election is made, the parent includes as income taxable at the parent's rate any gross income of the child in excess of $2,100. With respect to the first $2100 for each child to whom the election applies, there is a tax of 10 percent of the lesser of (1) $1,050 or (2) the excess of the gross income of the child over $1,050. Under the American Taxpayer Relief Act of 2012 the 10 percent rate of tax is made permanent (it had been scheduled to increase to 15 percent in 2013).

UNREASONABLE COMPENSATION

The payment of an "excessive" amount to an employee for services rendered is considered to be unreasonable compensation. Whether compensation is excessive, and therefore unreasonable, is often determined by reference to payments by similar corporations to employees performing like services. The problem is most often encountered with regard to employee-stockholders, where a *salary* would be a deductible business expense to the businesses, but a *dividend* would be nondeductible.

Underlying any discussion of employee benefits is the assumption that, if challenged by the Internal Revenue Service, the increased compensation could be shown to be reasonable. Compensation includes not only money, but also payments "in kind." For example, all of the following are considered compensation: the personal use of an automobile, lodging for the employee's family while on vacation, premiums for group term insurance, medical expense reimbursements, premiums paid under an executive equity plan, and the value of life insurance protection under an endorsement split-dollar plan. It should be noted that no deduction is allowed for compensation that is paid to certain highly compensated officers of publicly-held corporations in excess of $1,000,000. See discussion on page 413.

However, it appears to be the experience of many accountants and tax advisors that the threat of a successful challenge by the Service is more imagined than real. This may often be due to a belated recognition by the courts, as well as the Service, that the business owner spent many years being underpaid while the business grew, and now has the "right" to compensation for those earlier services. After all, it was the owner who made the small closely-held business a success, and sooner or later he should be paid for his efforts. However, the determination depends on the circumstances of each situation.

VALUATION OF LIFE INSUANCE

Over the years it has been generally accepted among financial service professionals that, as a general rule, "unused premiums" were used for valuing a term life insurance policy and "net surrender values" were used for valuing a permanent life insurance policy. Although at one time these values were probably a fair approximation, today life insurance contracts are far more complex and these outdated rules do not always create reasonable approximations of fair market value. These general guidelines were developed during a time when life insurance policies were basically either whole life or annual renewable term. For these specific types of policies, in the absence of some serious health issue, the "net cash value" of a whole life contract is probably close to fair market value and the "unused premiums" on an annual renewable term is also a reasonable approach to determining fair market value.

In addition to whole life and renewable term, today's life insurance market includes a variety of level term, universal life, variable life, and equity index life products. Many of these universal life products come with long term or even lifetime guarantees. In many of them the guaranteed death benefit and not the cash value drives the policy values.

For tax purposes many tax professionals use an adjusted version of the "interpolated terminal reserve," or ITR, as the appropriate value of a life insurance policy (in fact, interpolated terminal reserve is specifically mentioned on IRS Form 712). In disagreement, many actuaries believe that ITR is actually a whole life term and not really applicable to a universal life or level term chassis product. The IRS has provided "safe harbor" calculations for valuation of policies transferred from qualified plans or transferred in compensation for services in employment scenarios.

When valuing a product other than whole life or annual renewable term most carriers today report a "reserve" value of some type, and many report an ITR value for term contracts as well. Some carriers use their statutory "book" reserve, while others use the tax reserve that they are required to hold. In the case of a product with a long-term guaranty, these reserve numbers (for both universal life and long-term level term) can create valuation numbers that are well in excess of premiums paid.

Unfortunately, valuation of today's life insurance products is very unsettled. The IRS has not provided clear guidance and carriers report using inconsistent methodology. When contemplating the transfer of a life insurance policy the carrier should be consulted about the policy's value *before* the transfer. With larger policies, if the carrier's valuation appears to exceed fair market value, consideration should be given to employing an independent valuation firm to appraise the policy before the transfer.

VARIABLE ANNUITIES

With a variable annuity the annuity owner has the opportunity to allocate his premiums among a number of subaccounts. In return for the opportunity to benefit from any appreciation in underlying investments, the owner assumes the risk that his investments may decrease in value, thereby resulting in lower accumulation values or a lower monthly income. The variable annuity is considered a "security" under federal law and anyone selling a variable annuity must have the required securities licenses and the purchaser must be given a prospectus (see footnote 3, page 291). The purchase can be made with either a single premium or a series of premiums (see Annuity Matrix, page 305).

In addition to a fixed or general account, the typical variable annuity might offer the following investment options: (1) growth or common stock fund; (2) balanced fund; (3) index fund; (4) global fund; (5) bond fund; (6) government securities fund; and (7) money market fund. Asset management or investment fees will vary depending upon the type of fund. In addition to an annual administration fee, an annual mortality charge is made for a guaranteed "death benefit" (e.g., provided the owner dies prior to age 80 his beneficiary is guaranteed to receive the greater of his original investment or the policy's value at the time of death, less withdrawals). Some contracts offer "stepped up" death benefits that lock in investment gains at a given point in time.

During the *accumulation* phase premium payments are applied toward the purchase of accumulation units. The value of an accumulation unit is determined by dividing the market value of the underlying investments by the total number of units outstanding. Dividends and capital appreciation or depreciation are reflected in the value of the accumulation units. The owner also has the option to transfer funds between investment subaccounts, subject to certain dollar amounts and timing limitations. Unlike mutual funds, all accumulations are tax deferred and transfers of assets between accounts are free of current income taxes. A decreasing surrender charge is generally applied if the annuity is surrendered within a given period (see chart, page 289).

During the *distribution* phase the annuity owner can cash in the contract, take periodic withdrawals, or annuitize the contract. All gains are taxed as ordinary income when distributed. Annuity payments can be received on a fixed or variable basis, or a combination of both, and can be paid as a single life annuity or joint and survivor annuity. If variable benefits are to be received the accumulation units are first exchanged for annuity units. Unlike accumulation units, the number of annuity units then remains constant. Variable benefit payments will differ from month to month, or from year to year, depending upon the value of the annuity units. A new living benefit feature currently being developed offers a guaranteed minimum account value, or minimum payout amount, regardless of the actual performance of the subaccounts. See also, the discussion of the Guaranteed Lifetime Withdrawal Benefit on page 417.

WELFARE BENEFIT FUND

A welfare benefit fund (WBF) is a fund (which is either taxable or a tax-exempt entity, as with a VEBA trust) into which employer(s) make deposits to provide specific benefits to their employees. Typical benefits include severance pay and preretirement death benefits. A WBF is not a qualified plan, nor is it a plan of deferred compensation (which would result in the employer losing his current tax deduction). To avoid classification as deferred compensation, plans are designed to: (1) include a broad group of employees; (2) cover businesses with more than one employee; (3) base funding on actuarial determinations; and (4) avoid any reversion of assets to employers.

Although strict limits are placed on an employer's deductions for contributions to a WBF, these limits do not apply to contributions made to a "10-or-more employer plan." By requiring the pooling of funds in a 10-or-more employer plan, it was expected that the plan would be "self-policing" (e.g., an employer would not be tempted to make excess contributions beyond that needed to pay promised benefits to its own employees since these contributions might benefit the employees of *another* employer).

Regulations have halted what the IRS considers abusive 10-or-more plans (e.g., plans purporting to guarantee payments based upon contributions for specific employees). Under these regulations a 10-or-more employer plan is a single plan: (1) to which more than one employer contributes; (2) to which no employer normally contributes more than 10 percent of the total contributions by all employers; (3) that does not maintain "experience-rating arrangements" with respect to any individual employer; and (4) that satisfies compliance rules (i.e., written plan document, record keeping, and right of inspection by the IRS and participating employers). A prohibited experience-rating occurs if an *employer's costs* or an *employee's benefits* are based upon the employer's overall experience (e.g., claims or expense experience, investment results, or over or underfunding). Although the regulations do not prohibit the use of cash value life insurance, they do express concern that any pass-through of premiums associated with an employer's employees may result in a prohibited experience-rating arrangement. Likewise, these regulations seem to provide no deduction for funding with cash value life insurance.

The single-employer welfare benefit plan to prefund post-retirement medical and life insurance benefits appears to offer an attractive supplemental employee benefit. However, it would be prudent to seek guidance from qualified counsel on plan design and any unresolved tax questions. See in general, IRS Notice 2007-65, IRS Notice 2007-83 and IRS Notice 2007-84.