

THE USE OF LIFE INSURANCE IN ESTATE PLANNING

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The principal role of life insurance, the type of insurance with which estate planning is primarily concerned, is to provide liquid funds to pay the costs of dying. These include, in addition to debts, administration and funeral expenses, expenses of the last illness, taxes, and the care of dependents. When one reflects that insurance is an asset which is as liquid as cash and yet is an earning asset, that it is worth more at death when needed and that the increase in value above the amount of premiums paid is not subject to the income tax, its importance in meeting these expenses is apparent.¹

In determining how best to utilize the assets of an estate, then, careful consideration must be given to the disposition of insurance. But beyond the problem with respect to the use of existing assets, one needs to be aware of the various specific uses to which insurance may be put. There is evidence that not enough estate owners and their advisers have been aware of the possibilities.² These perhaps can best be presented by considering small estates first, and then larger estates. Before so discussing the subject, however, it seems advisable to describe briefly the kinds of insurance and the types of settlement options available under the policies.

TYPES OF INSURANCE

Although there are a great many kinds of life insurance, each of them, except term insurance itself, is simply some combination of term insurance and investment. A term policy is one in which the insurer agrees to pay the face value of the policy if the insured dies during the stipulated term, nothing being paid if the insured survives.³ Sometimes referred to as "pure" insurance, this is, of course, low cost insurance.

The cheapest *permanent* insurance is ordinary or continuous-premium whole life insurance. In this kind of policy premiums are paid throughout life,⁴ but there is an investment feature which even-

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1. See Mehr, *Life Insurance: A Tool in Estate Planning*, 6 J. Am. Soc'y C.L.U. 227 (1952).

2. See the statistics, note 61 *infra*, on the liquidity of estates filing estate tax returns.

3. Huebner, *Life Insurance* 97 (4th ed. 1950); Mehr & Osler, *Modern Life Insurance* 34 (rev. ed. 1956).

4. Actually most of these policies are written as endowment at age 96 or 100, but for practical purposes it is considered that the insured must pay premiums throughout his life.

tually results in a substantial cash value. This arises because in a level-premium⁵ policy the insured pays a premium that is higher than is required for insurance in the beginning, the cash value being these extra premiums plus the investment return thereon. Another type of whole life policy is one in which premiums are paid for a limited time, such as twenty-payment life. In this type of policy the investment feature is such that the cash surrender value at the end of twenty years will be large enough to purchase a single premium policy of the same face value, so no more premiums need be paid. The policy is then "paid-up."

The most expensive insurance with periodic premiums is endowment, for in it the contract binds the insurer to pay the face amount of the policy not only on the death of the insured during the period but also on his survival of the period. It is a combination of decreasing term insurance and increasing investment.⁶ The relative costs and amount of investment of these various policies are indicated by the following table:⁷

Comparison of Rates and Values
(Policies Issued at Age 25)

Policy Form	Premium Rate per \$1000	Cash Values per \$1000	
		End of 10th year	End of 20th year
Continuous-Premium Whole Life.....	\$ 20.40	\$ 105.04	\$ 261.11
20-Pay Life.....	32.50	224.68	551.37
20-Year Endowment.....	50.34	410.26	1,000.00

5. A level-premium policy, which most policies other than term are, is one in which the amount of the periodic premium remains unchanged throughout the premium paying period. The premium is higher than required for insurance during the earlier years of the policy, and this excess premium, plus the earnings on it, is the investment portion, the basis for the cash surrender value. See Mehr & Osler, *op. cit. supra* note 3, at 183.

Insurance rates are figured on the basis of mortality tables—usually the American Experience or the 1941 CSO (Commissioners Standard Ordinary) Table, the latter being the newer and the one used most often now. The latter takes 1,000,000 lives at age 1 and shows the deaths each year, and the life expectancies of those remaining, through age 99, at which age 125 are still living. At age 25 this table shows 939,197 of the original group of 1,000,000 living at the beginning of the year, and 2705 dying during the year. If one were to insure every member of the group for \$1,000, payments for death during the year would be \$2,705,000. Dividing this by the number of persons alive at the beginning of the year (939,197), one gets \$2.88. This would be the base cost of term insurance for this year. At age 30 the figure would be \$3.56. Of course, other costs (administration, expenses, etc.) would be added to these figures to get the rate which an insurance company would need to charge.

6. Concerning whole life policies as endowments, see note 4 *supra*.

7. Taken from Mehr & Osler, *op. cit. supra* note 3, at 58. The cash value of policies that are participating is increased by dividends that are not withdrawn.

While the above policies account for the greatest amount of insurance in force, note should be taken of annuities and of at least one other combination. "The annuity has been called the 'upside-down application of the life insurance principle.'"⁸ In a sense an annuity is the opposite of insurance, for its function is the systematic *liquidation* of an investment, whereas insurance has as its main purpose the *creation* of an estate. Yet, the cost of each is computed from similar data (i.e., mortality and interest tables) and principles, and annuities usually are coupled with insurance. Thus a man at age 65 who has an estate of \$25,000—whether built up by annual payments under an annual premium annuity, by insurance proceeds or by other property—can purchase an annuity of about \$160 per month. If he should die within a year or two, however, his heirs are likely to feel cheated. By adding life insurance, the company can agree to continue payments to the annuitant or to his beneficiaries for a certain period of time or until the insurer has paid out at least \$25,000. The latter is a refund annuity. On the same facts such an annuity would yield about \$120 per month, the difference of \$40 between its monthly yield and that of a straight annuity being the cost of the life insurance.⁹

Among the many other combinations of insurance perhaps the most important is the "family income" policy. This type of policy provides for monthly income payments to the beneficiary if the insured dies within ten, fifteen or twenty years from the date of the contract, payments commencing upon death of the insured and continuing until expiration of the stipulated ten, fifteen or twenty years from the date of issue. Basically, this is decreasing term insurance, but it is usually combined with a continuous-premium whole life policy or attached as a rider to some permanent policy issued by the same company.

Mention should also be made of the variable annuity, apparently first issued by the College Retirement Equities Fund in 1952.¹⁰ Ordinary annuities are backed for the most part by investments in fixed dollar assets such as bonds and mortgages, and the annuities are paid in fixed dollar amounts which are arrived at on the basis of the probable earnings of such assets. The variable annuity, a product of thinking about inflation, is designed to give the annuitant some protection against rising price levels¹¹ and "an opportunity to share in the expected growth of the economy."¹² Assets behind the variable annuity are invested in equities—primarily common stocks. An annuitant pays

8. Mehr & Osler, *op. cit. supra* note 3, at 69. See also Huebner, *op. cit. supra* note 3, at 130.

9. The figures are from Mehr & Osler, *op. cit. supra* note 3, at 72.

10. Mehr & Osler, *op. cit. supra* note 3, at 84. See Johnson, *The Variable Annuity*, 7 *J. Am. Soc'y C.L.U.* 67 (1952), describing the College Retirement Plan.

11. It has risen approximately 2% per year since 1900.

12. Mehr & Osler, *op. cit. supra* note 3, at 85.

a premium of a fixed number of dollars which purchases "accumulation units" in the equity annuity fund. The value of such units fluctuates with the value of the fund. So a \$100 premium might buy ten units this year and eleven next year. When the annuity matures—these are generally annual premium deferred annuities for retirement—the total number of units accumulated is liquidated according to the annuity principle. That is, an annuitant with 300 units may be given an annuity of 25 units per year based upon his life expectancy. The actual number of dollars he will receive will vary from year to year, depending on the value of the units, which in turn depends upon the value of the equity fund.¹³

Although this contract varies from the conventional annuity to some extent, it is still based upon the annuity principle of shifting the risk that a person will "live longer than his funds will last."¹⁴ For this reason the Court of Appeals for the District of Columbia has held recently that it is an annuity contract subject to state insurance laws and not to the federal securities laws.¹⁵

SETTLEMENT PROVISIONS

The settlement provisions of the insurance policy are extremely important for estate planning purposes. Most policies state that on death of the insured settlement may be made under any one of several options. Four options are common:

1. **Interest.** The proceeds may be left on deposit with the company which agrees to pay the beneficiary interest at a stipulated rate, varying from two to three per cent.

2. **Fixed Period.** The proceeds are paid in a limited number of installments, the installments being such as to liquidate principal and interest in a limited number of years, usually one to thirty.

3. **Life Income.** Periodic (monthly, quarterly or annual) installments are payable for a period of ten, fifteen or twenty years and thereafter for life. The amount of each installment depends upon the type of annuity selected, the sex of the payee and the payee's age when the annuity commences.

4. **Fixed Amount.** Payments of a stated sum are made periodically until the proceeds and interest are exhausted.

13. *Id.* at 84. The College Retirement Plan permits the members of TIAA (Teachers Insurance and Annuity Association) to elect to have allocated to CREF (College Retirement Equities Fund) one-fourth, one-third, or one-half of their annuity premiums. On retirement the member can either leave his CREF shares in that organization's annuity units or he can elect to have the value of his units transferred to TIAA to purchase a fixed dollar annuity. Johnson, *op. cit. supra* note 10.

14. *SEC v. Variable Annuity Life Ins. Co.*, 257 F.2d 201, 205 (D.C. Cir. 1958).

15. *Ibid.* See note, 42 *Minn. L. Rev.* 1115 (1958). For the views of a trust officer, see Fralik, *The Variable Annuity*, 97 *Trusts & Estates* 636 (1958).

The third option is a type of refund annuity, and the policy may provide for a straight life annuity or a joint and survivor annuity for two persons.¹⁶

These options are available to the beneficiary if the insured has made no selection. If the insured has selected an option, some policies provide that the beneficiary may not alter or vary it, while others provide that the beneficiary may do so (may "commute") unless the insured has withheld the right.

Of course, all level-premium permanent insurance policies also contain the so-called nonforfeiture options. Under these provisions, after the policy has been in force for a period of time it always has value if it expires by nonpayment of premium or is surrendered. In either event the insured may take the cash value, and he generally is given the option of taking extended term insurance or a reduced amount of paid-up insurance. Other options, such as to convert the cash value to an annuity, may be stated in the policy or be granted as a matter of company practice.

SMALL ESTATES

With this review of the types of life insurance policies and settlement provisions completed, attention can be directed to the matter of planning for small estates. For this purpose a small estate is defined as one in which the value of the gross assets does not exceed \$120,000. It is also assumed that the estate owner is a married person.¹⁷ There is good reason for separating small estates, as so defined, from larger estates for the purpose of discussing the use of insurance in estate planning. If properly handled there should be no federal estate tax on such an estate and little, if any, state inheritance or estate tax.¹⁸ Aside from the dwelling and perhaps a small business, the main asset in the usual estate of this size, is, or should be, insurance: The basic problem here is family protection, and it is only through insurance that most people can hope to have enough assets to satisfactorily solve this problem.

16. See Redeker & Reid, *Life Insurance Settlement Options* §§ 2.6-2.7 (1957).

17. This is the normal situation. In cases where the person is single, the problems are more nearly like those of a larger estate even though the estate amounts to less than \$120,000.

18. In Missouri there should be no tax because the surviving spouse can receive up to \$80,000 of a \$120,000 estate without incurring a tax, and survivorship property and insurance payable to her are not subject to the Missouri inheritance tax. See *In re Gerling's Estate*, 303 S.W.2d 915 (Mo. 1957) (joint tenancy not subject to inheritance tax); Mo. Rev. Stat. §§ 145.020-3(3) (life insurance exempt), 145.090-2 (exemption of \$20,000 plus marital rights). See also Neuhoff, *Estate Planning Under the Missouri Inheritance Tax*, 23 Mo. L. Rev. 249 (1958).

How much insurance should be carried? Various suggestions have been offered, the mathematical ones varying from an amount sufficient to produce an income half as large as the insured could earn while living to an amount which will produce an income equal to the insured's probable earnings if he should survive.¹⁹ Obviously it depends on the particular facts in each case. Ideally, there should be enough, when coupled with other sources of income such as social security, to meet the other costs of dying and to support the insured's dependents during the period of dependency in accordance with a standard of living which is somewhere near that enjoyed during the life of the insured.²⁰

The type of insurance is not nearly so important as is the amount. In order to provide adequate protection at a cost within his means, however, the young man with a family may be required to carry a good bit of term insurance. It can be decreased as other insurance and assets increase. Frequently there will be some low-cost group insurance at the place of employment. Or the employer may make available "split dollar" insurance, an arrangement whereby the employer loans the employee without interest that portion of the premium equal to the increase in cash value of the policy, the employee paying the balance of the premium. If the employee dies or the employment terminates, the loan is paid from the proceeds or cash value of the policy, respectively. This operates very much like decreasing term insurance inasmuch as the net value of the insurance in the event of the insured's death decreases as the amount loaned increases. The Department of the Treasury has ruled that this is to be treated as though the employer had made annual interest free loans to the employee, so that the employer may not deduct his payments and the employee need not include anything in his income as a result of the employer's contribution.²¹ However inconsistent with other rulings this may be,²² it makes such insurance advantageous to the employee.²³

19. Huebner, *Life Insurance* 22 (4th ed. 1950).

20. Compare textual statement with: "Still others feel that an ideal arrangement for family protection would be such an amount of insurance, on the life income plan for the widow or other permanent dependent, with an adequate number of instalments certain to protect all children until they reached the age of self-sufficiency, as will guarantee an income throughout the life of the beneficiary (as long as it may be needed) equal to the family's share in the earnings of the deceased." *Ibid.*

21. Rev. Rul. 55-713, 1955-2 Cum. Bull. 23.

22. That it is inconsistent with the position taken with reference to insurance under a qualified pension or profit-sharing plan, where the participant must pay tax on the proportion of the premium paid for life insurance protection, see Pennick, *Uncertainties in the Use of Life Insurance*, Tax Counselor's Q., June 1958, p. 51, 54.

23. See generally Becker & Sloan, "Split-Dollar" and Bank-Financed Plans, 35

The choice between the various kinds of permanent insurance depends upon what one can afford and how much emphasis is to be placed upon investment as distinguished from protection. But certainly one cannot go wrong with ordinary or continuous-payment whole life insurance. The all-purpose policy, it is the cheapest of the permanent types of insurance, yet it builds up some cash value which in later years can be exchanged for a lesser amount of paid-up insurance.²⁴ On the other hand, one should steer clear of annuities, which are high cost and offer no protection or very little protection, unless adequate protection is otherwise provided, or there is a need to increase the spendable income of an annuitant,²⁵ or the employer contributes to its purchase.

If the insured has a family, his death before the children become self-supporting will create a situation in which the need of the family for income from the insurance estate probably will vary from time to time. Specifically, in addition to the need for funds to pay debts and expenses incident to the last illness and death of the insured, one must consider the need for income of the family unit (1) during the dependency period and (2) during the social security gap between the time when the youngest child attains eighteen and the time when the widow attains age sixty-two,²⁶ and (3) of the widow during the balance of her life. These several needs may be adequately provided for by a judicious use of the insurance options.

The need for a clean-up fund at death may be met by setting aside certain insurance proceeds for the widow as primary beneficiary, the estate being contingent beneficiary,²⁷ and leaving the amount with the company under the interest option with full right of withdrawal. Or, depending upon taxability of the proceeds by the state and the necessity of administration proceedings otherwise, the estate may be named the primary beneficiary.

Taxes 842 (1957); Blum, *Bank-Plan Financing and the Cost of Life Insurance*, 36 Taxes 377 (1958); Goldbert, *Cost of Life Insurance*, 36 Taxes 195 (1958).

24. See *Comparison of Rates and Values*, text at note 7 *supra*. Dividends left on deposit will increase the cash value, which can also be used to purchase an annuity.

25. Since the annuity uses up the capital, a given amount of money will purchase a much larger income for an elderly person as an annuity than could be secured by just investing the capital and using the earnings.

26. No benefits are paid during this period. Section 216(a) of the Social Security Act was amended and § 202(g) was added in 1956 to permit women to receive reduced retirement benefits at age sixty-two. 70 Stat. 809 (1956), 42 U.S.C. §§ 402(q), 416(a) (Supp. V, 1958).

27. Redeker & Reid, *Life Insurance Settlement Options* § 3.3 (1957). It is assumed that in an estate of this size the widow will be receiving all, or nearly all, of the assets.

In providing income, one could determine the income to be allotted to the wife over and above social security, place this amount of insurance proceeds under the life income option,²⁸ and then provide for additional dependency period and social security gap income by placing other proceeds under the fixed amount option.²⁹ "Under this option, provision may readily be made for periodic increase or decrease of instalments to synchronize with income from other sources or to reflect the time when each of the children becomes self supporting. It is also adaptable for change to some other settlement option at a later date."³⁰ (If the insured has a family income policy the income rider in effect provides a fixed income for a fixed period.)³¹

If the primary beneficiary is under fifty years of age and there is a desire to preserve some values for the contingent beneficiaries, it is possible to work out a better combination of options. A portion of the proceeds is made payable to the beneficiary under the fixed period option for as long as twenty years, while the major portion of the proceeds is placed on the interest option for that period and then shifted to the life income, twenty-year certain, option. The beneficiary's income under such a plan can be made to approximate that which would be received by commencing the life income option immediately and some guaranteed amount can be preserved for the contingent beneficiaries for up to forty, instead of twenty, years.³² If permissible, the beneficiary may also be given the right to elect to postpone commencement of the annuity³³ and to commute at least a portion of the proceeds.³⁴

28. Generally under the twenty-year certain provision. See note 35 *infra* and text supported thereby.

29. Or under the fixed period option in the case of the social security gap period. See Redeker, *Life Insurance Settlement Options*, 97 *Trusts & Estates* 940, 941 (1958).

30. *Ibid.*

31. See text following note 9 *supra*.

32. See Redeker & Reid, *Life Insurance Settlement Options* §§ 3.10-3 (1957); Redeker *op. cit. supra* note 29, at 941. In the example given by these authors, approximately one-third of the insurance is placed under the fixed period option. This plan does not guarantee that the contingent beneficiaries will get any portion of the other two-thirds, but it increases the possibility of their receiving some of the proceeds. For beneficiaries over fifty or fifty-five, the life income, twenty-year certain, option would be preferable.

33. For information on what companies will permit change from the interest option to life income option, see Flitcraft, *Settlement Options* 22-23 (15th ed. 1956). Part 1 of this volume, which is published annually, contains company answers to a variety of questions. See also Redeker & Reid, *op. cit. supra* note 32, § 4.12.

34. See Flitcraft, *op. cit. supra* note 33, at 12-21. The policy should be examined. Some policies provide that the beneficiary will have the right of commutation (to take the present value of the remaining installments) if the right

The life income option should in most cases be one for twenty years certain. Generally the difference in income to the beneficiary between a ten- and twenty-year certain period is too slight to warrant the much greater shrinkage that is possible under the shorter period option where the primary beneficiary dies within the term.³⁵ Exceptional cases which justify the use of the straight life income with no guaranteed period certain are where a beneficiary is of advanced age and there is no desire to preserve anything for contingent beneficiaries or where there is a need to secure as much income as possible for the primary beneficiary.

It may be that there is no reason to qualify assets for the marital deduction in the particular estate, but if there is reason, insurance is a good asset to use for this purpose because under the options there may be little of the asset left at the death of the surviving spouse to be taxed as part of that estate. The proceeds of a policy, or a portion thereof, may be qualified for the deduction if left to the surviving spouse under any of the options so long as payment of interest or installments commences not later than thirteen months after death of the insured and the beneficiary has the power to appoint all amounts payable under the contract.³⁶ This may be accomplished although the insured names a contingent beneficiary as long as the surviving spouse is given an express power to appoint³⁷ or the settlement names the survivor's estate as contingent beneficiary.³⁸ However, in view of *Eggleston v. Dudley*,³⁹ the policy should be examined to make certain

is not withheld; others provide that there is no such right unless expressly granted by the insured. In any event it is worthwhile for the insured to name an option even though the right of commutation is given; some policies provide that if the insured decedent has not selected an option, his designation of contingent beneficiaries is cancelled and the primary beneficiary may name others.

35. If a man dies leaving a widow fifty years of age as beneficiary under a \$10,000 policy, she would receive \$40.20 per month under a ten-year certain policy and \$38.40 a month under a twenty-year certain policy, a difference of only \$1.80 per month. If she died after receiving one payment, the total payments the company would make to her and to the contingent beneficiaries would be \$4,300, a shrinkage of \$5,700, under the ten-year certain option; but they would receive \$7,300 under the twenty-year certain option, a shrinkage of only \$2,700. These figures are based on a current policy which uses a two and one-half per cent interest rate. Redeker, op. cit. supra note 29, at 942.

36. Int. Rev. Code of 1954, § 2056(b)(6).

37. See Clapp, Life Insurance and Estate Planning, 28 Taxes 63, 75 (1950), suggesting that the companies will give the widow the right to direct payment to her estate but that few will permit a provision authorizing her to appoint to persons named in her will. See also Trachtman, Estate Planning 101 (1958). Of course, a power to commute would be an inter vivos power to appoint to herself and sufficient to satisfy the statute. Ibid.

38. U.S. Treas. Reg. § 20.2056(e)-2(b)(3)(iii) (1958).

39. 154 F. Supp. 178 (W.D.Pa. 1957), rev'd on other grounds, 257 F.2d 398 (3d Cir. 1958).

that it does not require the beneficiary to be alive when proofs of death are filed in order to be entitled to the proceeds of the policy.⁴⁰

If there are minor children in the family the insurance may be made payable to them in equal or designated shares, either as direct or as contingent beneficiaries.⁴¹ But it is difficult to forecast in advance the amount of income the beneficiary may need when his rights vest, and the company may require the appointment of a guardian before making payment on behalf of a minor beneficiary. The most flexible plan is to establish a trust for the children, giving the trustee discretion to expend the principal and income for their support and education in such manner and in such shares as he shall determine.⁴² However, the amount of insurance may not justify the cost of this solution to the problem. It may be that the insured knows a private individual whom he would be willing to name as trustee on a simple trust to receive the proceeds in such manner as the trustee shall elect and to expend all sums received for the support and education of the minor beneficiaries until they come of age, and then to pay over all unexpended sums to them in shares designated by the insured.⁴³ Since the trustee has no investment responsibilities, this is a simple and inexpensive solution. At any rate, it would seem desirable generally for the insured not to select an income option, but to indicate retention of the proceeds under the interest option with the right in the beneficiaries to withdraw or elect any installment option. This is a more flexible arrangement whether a trustee is named as beneficiary for the benefit of the children or the children are named directly as beneficiaries.⁴⁴

LARGER ESTATES

While insurance is almost always a necessity for the purpose of providing family protection in the small estate, this need declines as the size of the estate increases. The income from a larger estate will support the family. If there is need for management and investment services and for flexibility in controlling payments to beneficiaries, the larger estate can afford a corporate trustee. But this does not mean that insurance will not be of value. It may be very useful for a clean-up fund, to supply funds needed to transfer a business, to achieve tax

40. Companies whose policies are so worded will amend them. Redeker, *op. cit. supra* note 29, at 944.

41. Care should be taken in designating the beneficiaries. "Children born of the marriage of the insured and his said wife" would exclude children by an earlier or later wife. "Children of the insured" includes all his children; adopted, for example. See Redeker & Reid, *op. cit. supra* note 32, at 192.

42. See Shattuck & Farr, *An Estate Planner's Handbook* § 23,C (2d ed. 1953).

43. Insurance companies are more likely to permit such trustees to exercise the options. Redeker, *op. cit. supra* note 29, at 943.

44. *Id.* at 942.

purposes, or simply for investment. In other words, the carrying of insurance in a large estate is not so much a matter of necessity; it is rather a matter of choosing between competing methods of investing the assets for income and of conserving them for the next generation.

Investment.

Insurance has many features desired for an investment: safety of principal, liquidity, avoidance of managerial care and freedom from reinvestment. In addition, state statutes generally exempt all or a certain amount of insurance proceeds from the claims of creditors of the insured, and many even exempt the cash value of policies payable to a named beneficiary.⁴⁵ Also, it usually is possible to secure protection from the creditors of the beneficiary to some extent by having the insured designate an optional installment settlement with added spendthrift clause, or by making the proceeds payable to a trustee of a spendthrift trust.⁴⁶ Further, although the beneficiary of life insurance has been personally liable for the federal estate tax to the extent of the proceeds since 1918,⁴⁷ the federal income tax statute has never contained a similar provision, and the Supreme Court recently held, in *Commissioner v. Stern*,⁴⁸ that the government could not hold a widow-beneficiary liable for the insured's income tax where his creditors could not hold her liable under the state exemption statutes.⁴⁹

But what rate of return can the investor expect? It may be assumed that the large estate owner would be interested only in a single pre-

45. Vance, Insurance § 124 (3d ed. 1951). The Missouri statute exempts to a widow-beneficiary that portion of the proceeds attributable to premiums not in excess of \$500 per year. Mo. Rev. Stat. § 376.560 (1949). The Illinois statute exempts "all proceeds payable because of death of the insured and the aggregate net cash value of any or all life and endowment policies and annuity contracts payable to a wife or husband of the insured, or to a child, parent or other person dependent upon the insured. . . ." Ill. Ann. Stat. c. 73, § 850 (1937).

46. 6 American Law of Property § 26.18 (Casner ed. 1952); 1 Scott, Trusts § 87.1 (2d ed. 1956).

47. Worthy, Federal Taxation Affecting Life Insurance, 36 Taxes 737, 750 (1958). The statute is now Int. Rev. Code of 1954, § 6324(a)(2).

48. 357 U.S. 39 (1958); see note 37 Ore. L. Rev. 361 (1958).

49. However, in the companion case of *United States v. Bess*, 357 U.S. 51 (1958), the Court held that where the government secured a lien upon the "property" of the insured prior to his death under section 3670 of the Internal Revenue Code of 1939 (now section 6521 of the Internal Revenue Code of 1954) the lien attached to the cash surrender value of the policy and, to that extent, to the proceeds of the insurance in the hands of the beneficiary. For comment on the procedural effect these cases will have, see Worthy, *op. cit. supra* note 47, at 755. See also Williams & Baer, Life Insurance Proceeds and Transferee Liability for Income Taxes, 36 Taxes 89 (1958).

mium policy.⁵⁰ The suggestion has been made that to find the real rate of return the amount of the investment must be determined by deducting from the single premium the cost of the decreasing amount of insurance at risk each year. If this is done, the investment yield on a policy taken at age thirty-five is approximately two and one-half per cent compounded annually provided the policy is held for fifteen years, more if held for a longer period.⁵¹ However, if the investor does not need insurance, he may not consider its cost. If no deduction is made for insurance and the total premium is treated as investment, the yield on similar facts would be something over one and one-half per cent compounded annually if held for fifteen years. Of course, if the policy is held until death there is a very great likelihood of some additional gain, as well as the possibility of a much larger gain, from the insurance.⁵²

Consideration must also be given to other factors in determining the net return from the investment. The insured can defer cashing in the policy until his income tax situation is favorable, the gain not being taxed until the policy is surrendered.⁵³ Or, if he does not cash in the policy prior to his death, the gain passes to the beneficiary free of income tax.⁵⁴ The effect of this non-tax feature on the net rate of return when the insured is in the fifty per cent or higher income tax bracket is obvious. Finally, if the proceeds pass to the surviving spouse as beneficiary under one of the optional methods of settlement, other than the interest option,⁵⁵ the first \$1000 of the "interest element"⁵⁶ is excluded from the beneficiary's gross income. The install-

50. There would not be enough investment in a policy requiring annual premiums. As to loans to purchase single premium policies, see text supported by notes 70-71 *infra*.

51. Mehr & Osler, *Modern Life Insurance* 117-18 (rev. ed. 1956). The actual figures are 2.425 per cent compounded annually if held for fifteen years, and 2.978 per cent if held for thirty years. This is based on \$20,000 face amount of non-participating insurance at a single premium of \$10,575, from which is subtracted \$1,104 for term insurance over the fifteen-year period. Thus, the net investment under this theory is \$9,471; the value of the policy at the end of fifteen years would be \$13,569. *Ibid*.

52. This is paid-up and not endowment insurance, of course.

53. Upon surrender of the policy for a lump sum payment the insured is taxed upon the difference by which the amount received exceeds his cost (total premiums, minus dividends). *Int. Rev. Code of 1954*, § 72(e) (1). The gain can be spread over 3 years. *Id.* § 72(e) (3).

54. *Int. Rev. Code of 1954*, § 101(a) (1).

55. *U.S. Treas. Reg.* § 1.101-4(h) (1958), citing *Int. Rev. Code of 1954*, §§ 101(c), 101(d) (4).

56. Because the Code provides for a straight proration of the face amount of the policy over the period with respect to which payments are to be made and includes as income amounts not excluded by this proration, the amount treated as income does not exactly correspond to interest, but it is treated as though it were. *Int. Rev. Code of 1954*, § 101(d).

ment options are currently written at an average two and one-half per cent guaranteed interest rate, but with participating dividends, which are also excluded as "excess interest" under the Internal Revenue Code and regulations,⁵⁷ the effective rate is something over three per cent. Where the exclusion operates, the rate of return would be the equivalent of more than four per cent to a surviving spouse who was in even the twenty-five per cent bracket.

The amount of insurance proceeds which will enable one to make full use of this exclusion depends upon the type of option chosen and, in the case of the life income option, the age and sex of the spouse. Under the income tax regulations the value of any refund feature is deducted from the proceeds and the remainder is divided by the life expectancy of the beneficiary to get the amount attributed annually to return of capital. The balance of the annual payment is considered as interest.⁵⁸ If this rule is applied to an option to pay a widow who is fifty years of age a monthly income for twenty years certain and thereafter for life, using three per cent as the interest rate, it will be found that \$50,000 will yield approximately \$953, which would be \$47 less than the exclusion. If the age selected is sixty years, \$55,000 would yield approximately \$1024, of which \$24 would be taxable.⁵⁹ Assuming that a twenty-year fixed period option is chosen, the age and sex becomes immaterial, and \$60,000 at three per cent would yield approximately \$967 "interest" each year, all of which could be excluded.⁶⁰ At least to this extent insurance offers a good investment to the large estate owner.

57. Int. Rev. Code of 1954, § 101(d)(1)(B); U.S. Treas. Reg. § 1.101-4(a)(2), Example 1.

58. U.S. Treas. Reg. §§ 1.101-4(c), 1.101-4(e) (1958).

59. Under Table I of U.S. Treas. Reg. § 1.72-9, the life expectancy of a woman at age 50 is 29.6 years and under Table III the refund feature is 9 per cent. On \$1000 of proceeds the excess interest would be figured as follows: \$1000 minus \$90 (refund feature) equals \$910. This figure divided by 29.6 (life expectancy) gives \$30.74, the prorated amount to be excluded each year. The annual payment is \$49.80 (\$4.15 per month times 12). Subtracting the prorated amount (\$30.74), one gets \$19.06 as the interest element per \$1000. This would be \$953 for \$50,000.

For age 60, the life expectancy is 21.7 years, the refund feature is 18 per cent, and total payments per \$1000 of proceeds is \$56.40 per year in the company selected.

U.S. Treas. Reg. §§ 1.101-4(c), 1.101-4(e) (1958) direct one to use life expectancy and per cent of value of refund features of the company in making calculations. The above calculations, however, using Tables I and III of U.S. Treas. Reg. § 1.72-9 (1958) illustrate the method and give approximately the same result.

60. Here there is no refund feature to be deducted. So dividing by 20, the prorated amount per \$1000 of proceeds is \$50. The payments to the beneficiary total \$66.12 each year, giving \$16.12 as interest element per \$1000.

Clean-up Fund.

The large estate has considerable need for cash to pay expenses of administration, taxes and other such costs of death, a need which the treasury's statistics on estate tax returns indicate is not being met.⁶¹ Furthermore, any insurance proceeds payable to named beneficiaries must bear a pro rata share of the estate tax unless the will provides otherwise,⁶² and the insured usually will want the beneficiary to take free of the tax, particularly where the proceeds are left under an installment option.⁶³ The insured, then, should provide a fund to pay the taxes and other death costs. Without liquid funds the estate may be compelled to sacrifice assets by ill-timed sales because of the need for ready cash. Insurance, being a liquid but earning asset, provides a very good source for the necessary funds.

Generally such insurance should be made payable to the estate. This has the effect of increasing the size of the estate and the tax, requiring that more insurance be carried, but it has other advantages and may be the only way of providing funds. Further, the increase in size of the estate is offset to some extent by the use of other funds to pay premiums.⁶⁴ If the wife is to be the sole beneficiary of the estate, it is possible to keep the proceeds out of the insured's estate by having her take out the insurance or by having the insured make a gift to her of insurance for this purpose.⁶⁵ In some cases liquid funds may also be provided by an inter vivos gift of insurance to other beneficiaries or to a trustee with an agreement for purchase of estate assets or a loan to the insured's executors.⁶⁶ An agreement that the

61. The statistics for 1955 returns (where there was no time to take advantage of the 1954 act repealing the premium payment test) shows 36,595 returns with a total gross estate value of \$7,467,443,000 and \$468,498,000 of life insurance—\$122,604,000 in nontaxable estates and \$345,894,000 in taxed estates. It is estimated that insurance accounted for only 5 per cent of the adjusted gross estates. Brown, *How the Premium Payment Test Affects Small Business*, 36 *Taxes* 295, 296 (1958). "A shocking fact shown by this tabulation is that the average amount of taxable insurance in taxable estates was only \$13,700 in 1950 returns and \$13,359 in 1955 returns." *Ibid.* Other figures show that these estates had urgent needs for cash of \$1,957,024,000 but only had liquid assets in cash and federal bonds of \$1,204,934,000. If all insurance were added in, and it could not be because much of it would be unavailable for this purpose, the liquid funds would fall far short of needs. *Ibid.*

62. *Int. Rev. Code of 1954*, § 2206.

63. Trachtman, *Estate Planning* 91 (1958). See Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 *Wash. U.L.Q.* 327.

64. The net increase in the estate will be approximately the difference between the proceeds and the amount of premiums paid.

65. See text supported by note 85 *infra*.

66. See Mason, *A Lawyer Looks at Estate Planning*, 94 *Trusts & Estates* 572 (1955). A trust may be created inter vivos to hold the policies until death. Such a trust is not testamentary. *In re Albert Anderson Life Ins. Trust*, 67 *S.D.* 393,

beneficiary will pay the taxes or other claims against the estate, however, will have the effect of making the proceeds part of the taxable estate.⁶⁷

Transfer of Business Interest.

The estate owner may be a partner or large shareholder in a business and may be party to a buy-and-sell agreement covering the interest of the party first dying. If so, the agreement is almost certain to include a provision requiring the carrying of life insurance, either by the individuals or by the business entity. There has been considerable controversy lately concerning the tax effects of these transactions.⁶⁸ Since the matter is discussed elsewhere in this issue of the *LAW QUARTERLY* in connection with buy-and-sell agreements,⁶⁹ it is sufficient here to note that, whatever the ultimate outcome of the controversy and its effect upon the form of such transactions, it is clear that insurance will continue to be used for this purpose because in the usual case it is the only way the parties can be sure that the purchaser will have the required funds. And under the Internal Revenue Code of 1954 the surviving party to an agreement which requires the individual parties to carry insurance may find it profitable to purchase the insurance on his life owned by the estate of the deceased party.⁷⁰

Tax Planning.

While tax planning with respect to insurance generally takes the form of working out settlement arrangements for policies that may be part of the estate or of attempting to assign these policies by way of gift so as to remove them from the estate, there have been occasions when insurance was purchased by the insured solely with the expecta-

293 N.W. 527 (1940); 1 Scott, *Trusts* § 84.1 (2d ed. 1956). As to the designation of testamentary trustees as beneficiaries of policies, see Cooper, *Testamentary Trust for Insurance?*, 97 *Trusts & Estates* 113 (1958).

67. U.S. Treas. Reg. § 20.2042-1(b)(1) (1958).

68. See, e.g., Lawthers, *The Fragile Bark of the Small Corporation*, *Tax Counselor's Q.*, Mar. 1958, p. 97; Sneed, *A Defense of the Tax Court's Results in Prunier and Casale*, 43 *Cornell L. Q.* 339 (1958); Note, 71 *Harv. L. Rev.* 687 (1958). The main problems arise in connection with entity plans, and include such questions as whether the payment of premiums by a corporation is a dividend to the stockholders at the time made, whether a dividend results at the time the deceased stockholder's stock is redeemed, whether redemption results in a dividend to the estate of the deceased stockholder. Also, may payment of premiums by the corporation result in an accumulated earnings tax? If the transaction results in no dividend, then any increase in value of the surviving stockholders' stock as a result of the redemption will be taxed only as capital gain.

69. Kehr & Zafft, *Tax Planning in Business Purchase Agreements*, with Sample Clauses, 1958 *Wash. U.L.Q.* 398.

70. He may treat the proceeds as exempt from income tax under Int. Rev. Code of 1954, § 101(a)(2)(B), contrary to the rule previously existing.

tion of obtaining some tax advantage. An example is the purchase with borrowed money of single premium insurance or annuities. The tax avoidance feature is the deduction of interest on the loan while the earnings credited by the insurance company on the premium are not taxed.⁷¹ This scheme has been frustrated by section 264 of the Internal Revenue Code of 1954. However, since the Code does not treat the policy as a "single premium" one if the premiums are stretched over a period of more than four years, it may be that some tax avoidance in this manner is still feasible.⁷² But most of the tax planning with respect to insurance will consist of making settlement arrangements or in taking steps to exclude from the insured's estate the proceeds of insurance policies which have been purchased for investment, where the tax factors play a part in selecting insurance as already indicated, or will involve other purposes previously discussed.

Regarding policies which are part of the estate two points may be noted. First, what has been said previously⁷³ with respect to the desirability of qualifying insurance for the marital deduction in the small estate applies also to the large estate, use of the life income option being particularly attractive where it will tend to reduce an otherwise large taxable estate of the surviving spouse.⁷⁴ Second, the estate owner may have endowment policies which are nearing maturity and which permit the insured to take the cash at maturity or elect an annuity. Prior to the 1954 Code the indications were that if the policy reached the maturity date without an election being made the insured was in constructive receipt of the proceeds, and the difference between the face value and the premiums paid was income to him at that time.⁷⁵ The 1954 Code gives the insured sixty days after maturity of the policy to make the election.⁷⁶ He may very well desire to elect an annuity or joint annuity, with a term certain, in order to spread out

71. See *United States v. Bond*, 258 F.2d 577 (5th Cir. 1958), where the taxpayer bought a single premium, thirty-year maturity annuity, paying \$100 cash and executing an annuity loan note for \$100,000, providing for payment of interest in advance. He was permitted a deduction for interest paid prior to 1954. Cf. *Fidelity-Philadelphia Trust Company v. Smith*, 356 U.S. 274 (1958), where the decedent used his own money to purchase annuities which were required as a condition to the issuance of insurance policies which he assigned by way of gift.

72. Bittker, *Federal Income, Estate and Gift Taxation* 175 (2d ed. 1958). But there is always a question of whether the amount is interest. *W. Stuart Emmons*, 31 T.C. No. 4 (1958); see *United States v. Bond*, 258 F.2d 577, 584 (5th Cir. 1958) (dissenting opinion).

73. See text supported by notes 36-40 supra.

74. An annuity liquidates the investment. See text supported by note 8 supra.

75. See *Blum v. Higgins*, 150 F.2d 471 (2d Cir. 1945).

76. Int. Rev. Code of 1954, § 72(h). This section applies if the election is to take an annuity. It does not affect the situation involved in *Blum v. Higgins*, supra note 75, where the insured was taxed when he elected option A, to leave the amount on deposit at three per cent interest.

the income under the more favorable annuity rule for income taxation⁷⁷ and have any remainder qualify for the marital deduction.⁷⁸

Attempts have been made in this situation to convert the income element in the annuity or endowment insurance to capital gain by selling the contract prior to maturity. Recent decisions in the Tax Court and the Court of Claims have reached diverse results. Although the former court allowed capital gains treatment,⁷⁹ the Court of Claims, after pointing out that the gain would be ordinary income if the contract were surrendered to the insurance company prior to maturity,⁸⁰ stated that the insured could not thus alter the character of his gain by selling to another person.⁸¹ The court relied upon *Hort v. Commissioner*.⁸² It also pointed out that the guaranteed interest distinguished the insurance contract from corporate stock.

Exclusion of insurance proceeds from the insured's estate may be accomplished by inter vivos gift of the insurance or by having someone other than the insured purchase the insurance.

Prior to 1954 insurance was included in the insured's estate for estate tax purposes if the proceeds were payable to his personal representative, if the insured possessed at his death incidents of ownership, or if the insured paid the premiums.⁸³ The 1954 Code eliminates the payment of premiums test but provides that "incident of ownership" includes "a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law)" if its value exceeds five per cent of the value of the policy immediately before the insured's death.⁸⁴

Any wealthy person should consider making gifts,⁸⁵ and it is now possible to make gifts of life insurance. The gifts will be subject to

77. Int. Rev. Code of 1954, § 72. Under this section the annual return of the annuity is multiplied by the life expectancy of the annuitant to get the expected return. The cost is divided by the expected return to get the percentage of each payment that is excluded from income. This exclusion percentage applies to all payments received even though the annuitant lives beyond his life expectancy and thus more than recovers his investment in tax exclusions.

78. See Trachtman, *Estate Planning* 74 (1958).

79. Percy W. Phillips, 30 T.C. No. 87 (1958) (Harron, J., dissenting).

80. Citing *Avery v. Commissioner*, 111 F.2d 19 (9th Cir. 1940). Accord, Int. Rev. Code of 1954, § 72(e) (2) (B).

81. *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958).

82. 313 U.S. 28 (1941) (payments by a lessee to a lessor for cancellation of lease held income to the lessor, the court stating the payments to be a substitute for future rent).

83. Int. Rev. Code of 1939, § 811(g).

84. Int. Rev. Code of 1954, § 2042(2).

85. See Neuhoff, *The Use of Graphs and Tables in Estate Planning*, 1958 Wash. U.L.Q. 346. See also Schuyler, *Why and When to Assign Life Insurance*, *Tax Counselor's Q.*, June, 1958, p. 1.

the gift tax, but the tax is on the present value rather than the face value,⁸⁶ and the transfer to an adult should be regarded as the transfer of a present interest qualifying for the \$3000 annual gift tax exclusion.⁸⁷ Inasmuch as the transaction will be open to attack as a gift in contemplation of death for three years after the date of the transfer,⁸⁸ and payment of premiums during the last three years before death may result in inclusion in the insured's estate of a proportionate amount of the insurance collected at his death,⁸⁹ it is desirable that the insured avoid payment of premiums after the transfer if possible.

This might suggest the use of a funded insurance trust, were it not for the fact that the income from such a trust would be taxed to the settlor and possibly the trust property, as distinguished from the insurance, would be part of his estate.⁹⁰ But gifts in trust of insurance on the life of another offer an attractive opportunity, for the provision taxing funded insurance trust income to the settlor applies only where the insurance is on the settlor's life. This fact has given rise to "grandfather" trusts in which A insures his son's life for the benefit of the son's children and assigns the policy to a trustee with funds sufficient to yield an income large enough to pay the premiums on the insurance. The corpus and insurance proceeds become one fund for the benefit of the grandchildren on the insured's death.⁹¹ Income from the fund will be taxed to the trustee during the insured's life at the lowest rate, and the only other tax is a possible gift tax. That is, neither the insurance trust corpus nor the insurance proceeds are taxed to A.⁹²

If the wife has considerable property of her own, she may establish a similar trust, using insurance on the life of the husband. By utilizing the gift tax exemption and exclusions and making the proceeds payable to the children for life, remainder as they shall appoint under a special power, it is possible to have the income from the trust taxed to the trustee during the life of the insured, avoid any gift tax, and avoid having the insurance taxed to the estates either of the husband or the wife.⁹³

86. See U.S. Treas. Reg. § 25.2512-6 (1958) for the method of determining the present value.

87. Casner, *Estate Planning* 253, n. 52 (2d ed. 1956). Regarding a minor, see *id.* at 254, *Int. Rev. Code of 1954*, § 2503(c).

88. *Int. Rev. Code of 1954*, § 2035(b).

89. *Liebmann v. Hassett*, 148 F.2d 247 (1st Cir. 1945).

90. *Int. Rev. Code of 1954*, § 677(a) (3).

91. *Lowndes & Kramer, Federal Estate and Gift Taxes* 860-61 (1956).

92. It is assumed that the trust is irrevocable and the assignment of policies absolute.

93. *Trachtman, op. cit. supra* note 63, at 78.

There are other instances, of course, where insurance on the life of one other than the estate owner⁹⁴ or taken out by another on his life is advisable.⁹⁵

The transferor making a gift of insurance should make certain that he retains none of the incidents of ownership.⁹⁶ There was some fear that the interest of the transferor as a possible heir of the transferee might be held to be a "reversionary interest," but the treasury regulations have eliminated this possibility.⁹⁷

To revert to the premium payment test,⁹⁸ a court of appeals decision has cast a slight doubt that it was ever valid.⁹⁹ On the other hand, the Department of the Treasury sought to have the Technical Changes Bill of 1958 amended to include the excess of death proceeds of a life insurance policy over its cash value immediately prior to death in the taxable estate of the insured if he paid the premiums.¹⁰⁰ One cannot be sure, then, that the premium payment test will not be restored. But it seems unlikely that the present favorable treatment of insurance income will not be continued. In any event, life insurance, because of its unique importance in meeting the costs of dying, will continue to have a major role in estate planning.

94. Thus he may insure his wife's life to protect against loss of the marital deduction if she should die before him. *Id.* at 77; Lowndes & Kramer, *op. cit.* supra note 90, at 862. To keep the insurance out of the husband's estate it can be made payable to a trustee for his children. *Ibid.*

95. Accident insurance may be owned and paid for by the wife. Trachtman, *op. cit.* supra note 63, at 74.

96. If an insured makes the proceeds payable to an irrevocable inter vivos trust but retains the right to change the beneficiary of the insurance policy, he has retained an incident of ownership so that the proceeds will be included in his estate. *Farwell v. United States*, 243 F.2d 373 (7th Cir. 1957), 12 Ark. L. Rev. 120 (1958).

97. U.S. Treas. Reg. § 20.2042-1(c)(3) (1958). Prior to this regulation, it had been suggested that assignment of insurance to a relative be done by means of a trust with an ultimate remainder to charity, to negate any reversionary interest in the insured. *Bowe*, *Tax Planning for Estates* 53 (2d rev. ed. 1955). Cf. Lowndes & Kramer, *op. cit.* supra note 90, at 301.

98. See text supported by note 82 supra.

99. *Kohl v. United States*, 226 F.2d 381 (7th Cir. 1955). The court held the test unconstitutional. For comment, see Lowndes & Kramer, *op. cit.* supra note 90, at 281.

100. See *Brown*, *op. cit.* supra note 61, at 295. See also Mitchell, *Handling Life Insurance in Estate Planning*, 22 Albany L. Rev. 71, 77 (1958).