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LIFE INSURANCE IN ESTATE PLANNING

by

Joe C. Stephens, Jr.* and Jack Gray Johnson**

VOLUMES have been written about life insurance in estate planning and especially about the methods of “properly” arranging life insurance for individuals and businesses. Nothing that the estate planner needs has been omitted from these volumes with the possible exception of a few prosaic practical suggestions. By choice, therefore, this Article omits a detailed analysis of the taxation of insurance and employs a pragmatic, not a scholarly, approach to life insurance in estate planning. Consequently, many arrangements of limited application which do not occur frequently in practice will not be covered because of space limitations.

Frequent references to local law are necessary in determining the arrangement to be used, and we will usually choose to refer to the law of Texas, which we profess, sometimes with trepidation, to know. Our discussion is for the average practitioner, not the learned estate planner, and it assumes that the reader knows little more about life insurance than the intense pain of paying premiums. Therefore, we will include some discussion of the nature of the insurance policies themselves. Our primary emphasis will be on making certain that life insurance achieves its most useful function as an integral part of the estate plan. Necessarily, some discussion of the basic background knowledge necessary for estate planning in the life insurance area must be covered first, but we have attempted to devote more than the usual amount of space to the practical application of this knowledge.

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2 Better phraseology might be that the law of Texas is so confusing that we use it so that no one can categorically point out our errors. See Huie, Community Property Laws as Applied to Life Insurance, 17 Texas L. Rev. 121 (1939), 18 Texas L. Rev. 121 (1940); Stephens, Life Insurance and Community Property in Texas—Revisited; 10 Sw. L.J. 343 (1936).
3 See Shattuck & Farr, An Estate Planner’s Handbook (2d ed. 1953), which contains
I. BACKGROUND INFORMATION

A. Types Of Policies

Life insurance policy forms are usually not prescribed by regulatory bodies, although the companies themselves and certain company practices are regulated strictly by most states, and specific clauses may be mandatory. While there are many types of policies, each tailored to fit a particular need or purpose, those which are most important fall into four categories.

1. Term Insurance

Pure term insurance is rarely encountered except in connection with the underwriting of group policies or in calculating reinsurance risks. It is usually written on an annual basis, and the premium generally increases from year to year depending on the mortality to be anticipated from an insured of the particular age and sex involved. An individual cannot normally procure pure term insurance but must resort to modified types such as five- or ten-year term policies (which usually contain certain added special features, such as convertibility within a specified time), or diminishing term policies. The latter type of policy normally has a constant annual cost throughout its life, usually twenty years, but under it the amount of death proceeds decrease approximately as the risk increases. A most useful form of term insurance is convertible and renewable at regular intervals, usually every five years, at a higher premium until the insured attains a given age, perhaps sixty-five. For young people, term insurance provides maximum protection at the lowest cost and thus is peculiarly suited to the family man on a limited budget.

2. Ordinary or Whole Life

The ordinary life policy in its elementary form guarantees the payment of a specified sum in the event of the death of the insured in consideration for premiums of a constant amount throughout his life. Actuarially, this entails a premium which is greater in the early years than is necessary to purchase pure term insurance and smaller

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*For a comprehensive survey of forms of policy contracts now in use see The Handy Guide To Life Insurance Policy Contracts (69th ed. 1960).

*E.g., the two-year incontestability provision, the limitations on the suicide defense, and similar provisions.

*We do not purport to be actuaries, but it is our understanding that the life expectancy of an infant one day old is somewhat less than that of a child one year old. Most companies do not insure day-old babies.
than an equivalent term premium in the later years. Therefore, the policy combines an investment aspect with an insurance function. It has cash values which increase through the years due to the excessive early premium and the fact that such early premiums will earn income under the company’s management. If the insured lives long enough, the cash values will equal the face amount of the policy. Accordingly, some policies provide for endowment, i.e., paying the insured the full face amount of the policy in cash during the insured’s lifetime, usually at some advanced age which varies from seventy to eighty-five. Since the initial premium of an ordinary life policy is larger than that of a term policy, ordinary life is better suited to an individual with a larger income who is reasonably certain that he will need insurance throughout his life despite changes which may occur in his family obligations. From the insurer’s viewpoint the amount “at risk” in an ordinary life policy decreases each year, since all that it has to “lose” on the death of the insured is the face amount of the policy less the cash value, a difference which gets progressively smaller and eventually disappears.

There are numerous variants of the ordinary life policy. One of these, which has become relatively less popular in recent years, is the 20-payment life policy, under which the insured completes his payments within twenty years. A single premium policy, although it superficially resembles certain other policies more than ordinary life, is merely an ordinary life policy which is purchased with a single payment, thus requiring no additional premiums from the insured. Occasionally, the “well-heeled” insured may also purchase what amounts to a paid-up policy by paying a number of premiums in advance on a discounted basis. The principal difference between this and a paid-up policy is that premiums paid in advance may be reclaimed by the insured in a manner slightly different from the method by which he can obtain, temporarily or otherwise, the cash values attributable to a fully paid-up policy. Also, upon the death of the insured any prepaid premiums are refunded.

3. Endowment Insurance

As mentioned above, some ordinary life insurance policies endow at an advanced age, and to that extent they approximate what is usually called an endowment policy. However, the latter usually endow at an earlier age than that specified in most ordinary life policies. The premiums are so much higher than an ordinary life or term that the primary function of an endowment policy may be defined as a method of providing an investment medium. Although
most endowment contracts guarantee that the face amount will be payable not only to the insured at the specified age, but also to his beneficiary in the event of his death prior to attainment of that age, the role of insurance has become quite secondary. Needless to say, the amount which the insurance company has at risk in a policy of this type is usually much smaller than in an ordinary life policy.7

4. Annuities

Although most policies now have limited annuity aspects both before and after the death of the insured, an annuity policy is designed specifically to provide an income during the life of the insured (or during the lives of the insured and one or more other persons), and the true insurance factors, if any, are of negligible importance. Annuities may be purchased either in installments or with a single premium, and the policy can be written so that the annuity payments start immediately or are deferred until some future date. The investment function alone is important. The only resemblance between an annuity and term life insurance, except that they may be sold by the same company and the same agent, is that in the former the insurer takes the risk that the customer will live too long and in the latter that the customer will not live long enough. It is interesting to note that actuarially an annuitant is expected to live much longer than an insured of the same age; the difference in calculation is not merely to line the coffers of the insurance company but is in recognition of the proven fact that a carefree annuitant is likely to live almost indefinitely.8 Although the annuity has a place in estate planning, it is not sufficiently useful in the small or moderately sized estate to necessitate any further reference to its existence in this Article.

B. Principal Policy Provisions

Although policy provisions are far from identical, competition and regulation have forced the inclusion of certain clauses in almost all policies. The insured is usually given a grace period of thirty-one days after the due date of any premium within which to pay without forfeiting his insurance. Also, an opportunity to reinstate the insurance after default in the payment of premiums is customarily allowed for a limited period, frequently five years, upon present-

7 If an applicant for insurance has a doubtful medical history he probably will be unable to obtain term insurance, but he may be able to obtain ordinary life on a rated (higher premium) basis, and he quite likely will be able to purchase an endowment contract without any rating. Companies will stand in line to sell him annuities.

8 It may well be that the magic cure for geriatric illnesses will be found not in the research laboratory but in the provision of adequate retirement income.
tion of evidence of insurability. The insured (or the owner) may change the beneficiary at will, although certain categories of beneficiaries may not be acceptable to the company. So long as the premiums are timely paid, the policy becomes incontestable after it has been in force for two years even though originally obtained by fraud, except that if the age of the insured has been misstated the premiums paid will purchase only that amount of insurance which such premiums would have purchased had the correct age been given to the company.

Most policies also grant the insured the right to change the plan, e.g., from term to ordinary life, provided that the premium for the new plan is not less than the premium on the original policy. This, in effect, means an upgrading—allowing the policy to be converted to another policy under which cash value builds up faster or, stated in another way, under which the company's insurance risk is less. Every policy will also specify the mortality table upon which it is based and the rate of interest (now usually 2 to $2\frac{1}{2}$ per cent) which is used in computing reserves and other benefits.

If the insured fails to pay a premium on any policy (except term insurance) and does not surrender the policy for its cash value, the policy usually provides extended insurance in the face amount of the policy for a certain number of years, depending on the age of the insured and on the cash values available. Alternately, the insured may at his option purchase paid-up insurance with the available cash values.

The insured or the owner may realize the cash value either by surrendering the policy, terminating the contract, and reclaiming such cash (possibly after paying a penalty euphemistically called a "surrender charge") or by negotiating a policy loan from the company and keeping the contract in force. The policy will specify the rate of interest on such a loan—usually five per cent per annum in current policies; however, frequently older policies require a higher rate. Another incidental way to borrow on the cash value is to file with the insurer what is known as an "automatic premium loan agreement," which requires the company, as long as cash values are available, to "lend" the insured an amount sufficient to pay any premiums which the insured has failed to pay. Such a loan bears the

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9 This may sound like a peculiarly decent concession on the part of the insurer considering that anyone who is insurable can obtain insurance anyway, but it may have some value. For example, an insured in good health might be able to reinstate a policy even though engaged at the time of reinstatement in a more hazardous occupation which would normally deny him coverage.

10 The possible existence of such "lapsed" policies on the life of any decedent should not be overlooked.
same interest rate as any other policy loan. The advantage of an automatic premium loan is that it avoids the inadvertent lapse of an insurance policy; however, it reduces the term of the extended insurance which would have been available had the policy merely gone into default.

In addition to the common clauses encountered in most policies, there are certain special benefits that may be purchased by paying an additional premium. One such special benefit provides automatic waiver of premiums in the event the insured (or occasionally some other person, such as the father of a minor insured) becomes totally and permanently disabled prior to a specified age, e.g., sixty or sixty-five. Closely related to this automatic premium waiver is an undertaking by the company to pay a monthly income to the insured upon his becoming totally incapacitated. Another well-known special provision is the double indemnity agreement which provides for payment of an extra benefit, usually equal to the face amount of the policy (hence the name), in the event the death of the insured is accidental. One rumor that needs to be squelched early is that all policies are identical. As noted above, even so standard a contract as the ordinary life policy may vary in certain respects. There are substantial variations in the provisions of different policies. For competitive reasons the net premiums are likely to be comparable, but the "fringe benefits" may vary so widely that the cost of a particular company's policy is definitely out of line. For example, the earnings of one company may be so favorable that the benefits received by its policy holders (except upon payment in a lump sum at death) will be much greater than those available to a policy holder of a less efficient company. Older policies frequently guarantee a rate of interest which is higher than presently obtainable. Also the annuity type options of such policies may be more favorable to the beneficiary because they were calculated from presently out-moded mortality tables under which the life expectancy of a beneficiary at a given age is much less than the "true" life expectancy of the beneficiary today.

11 Premium waiver and disability income both have a definite place in estate planning. They help to fill the otherwise unmet need for extra assistance in the event of complete incapacity of the insured. But there is little logic in double indemnity from an estate planning standpoint. There will be a requirement for a certain amount of life insurance, which will not be increased by the fact that death is accidental. As a matter of fact, while accidental death may be a traumatic experience for the survivors, it is usually less expensive than death after a prolonged illness.

12 An analysis made by one company compares ordinary life policies of twenty-three major companies with respect to the inclusion or non-inclusion of forty-five selected desirable features. It shows only five such features included in one, ten to twenty in
There are also a number of secondary variations such as special surrender charges against the cash value if the policy is dropped, the period during which a policy will remain in force if payments cease and the policy becomes extended term insurance, and other similar provisions. Most estate planners cannot economically analyze all of the variable benefits available and will be forced to rely on a competent life underwriter. However, under certain circumstances the secondary provisions may assume real importance. For example, if the insured is likely to surrender the policy for its cash value, then any charge made by the company on surrender is material. Of course, one need not worry about the surrender charge if it is clear that the policy will be retained permanently. If a planner wants a lump sum at the death of the insured, he will not be concerned about the annuity table employed, whereas if it is clear that a life annuity will be selected for the beneficiary widow, then this table may be the most significant policy provision.13

C. Principal Beneficiary Designations

The estate planner, in addition to recommending methods of payment, will usually be required to determine appropriate beneficiary designations. There are four primary categories of payees who may be designated to receive the death benefits from life insurance.

1. Named Individual

The most common beneficiary designation is an individual—frequently the spouse or a child of the insured. This category also includes class gifts such as "children of the insured."

2. Estate of Insured

Probably the next most common beneficiary is the estate of the insured. Ordinarily the policy itself provides that if there is no named beneficiary or if the named beneficiary does not survive the insured (and if there is no express alternative designation), then the proceeds will be paid to the insured's executors or administrators, i.e., his estate.

13 Rarely should an annuity option be forced on the beneficiary. Ideally, she should be permitted a choice at the death of the insured. In that event she can undergo a thorough physical examination and in the light of the results of that examination, and with due consideration for her financial and tax situation, she can exercise her selection against the company.
3. Inter Vivos Trust

With the increasing popularity of the life insurance trust, it is quite common to direct that the proceeds of the policy be paid to the trustee or trustees of an inter vivos trust, funded or unfunded, revocable or irrevocable.

4. Testamentary Trust

For reasons which will be discussed later, it has also become fashionable to designate the trustee of a testamentary trust as the beneficiary of insurance policies, although many companies have been reluctant to permit this procedure. This reluctance stems partly from the fact that there may be a long waiting period before the testamentary trustee qualifies and undertakes its duties, and partly, we suspect, from the unwillingness of monolithic organizations to embrace novel ideas. However, some companies do tolerate this arrangement, and it can be employed quite effectively in certain plans.\(^4\)

D. Methods Of Payment Of Proceeds

After the estate planner has decided to whom the policy should be paid, he must also decide how it should be paid. The latter decision may be eliminated if the chosen beneficiary is the insured's estate or a trust, inter vivos or testamentary, because most companies refuse to permit a trustee to exercise settlement options, at least in favor of the trust itself. Therefore, payment in a lump sum is the only choice in those cases. The first four of the following settlement options are more or less standard in modern insurance policies.

1. Monthly or Other Regular Installments in a Fixed Amount for a Fixed Period

At the option of the person authorized to make the selection (usually the insured, the owner or the beneficiary) the period selected for payments of proceeds may range from one to thirty years, and occasionally even longer. This option is usually selected only as a complement to other arrangements; for example, it may tide the widow over until she is eligible for social security.

2. Life Income for the Life of the Beneficiary

Every modern policy permits selection of life income for an individual beneficiary. The income is normally payable in monthly installments and is frequently coupled with the requirement that a

minimum number of installments be paid to the primary beneficiary’s estate or to some third party if the beneficiary dies before receipt of such minimum number of installments. Most policies permit the choice of 60, 120 or 240 minimum monthly payments. This is the basic settlement option, the widow’s friend.

3. Proceeds at Interest

The beneficiary may leave the proceeds with the insurer to draw interest, and the company will, for the lifetime of the beneficiary or some other period, retain the proceeds and pay the guaranteed interest thereon in regular installments. Frequently the beneficiary may at any time withdraw part or all of the principal, so that this may be called the “wait and see” option.

4. Specified Amounts Until Exhaustion of the Proceeds Plus Interest

Leaving the proceeds to the company to pay a fixed sum, usually monthly, will assure the beneficiary of a specific income for a period of time. The length of such period will be increased by virtue of any excess earnings which may be attributable to the policy. For planning purposes this is similar to option 1 above.

5. Special Arrangements by Negotiation

Most companies will hand-tailor an option to fit unusual requirements of a beneficiary or the beneficiary’s family; too often the willingness of companies to make such special arrangements on larger policies is completely overlooked by the estate planner. Such arrangements can be quite flexible and can complement most estate plans.

E. Creditors’ Rights

One of the principal merits of life insurance as an investment is its relative freedom from the attacks of creditors, either of the insured or of the beneficiary. Rarely does one hear the life underwriter extoll this virtue of his wares, although it may be the single most important advantage of life insurance. Perhaps the shy insurance man may feel that touting this quality would offend his sensitive customer, but it should be ever present in the mind of the estate planner, who knows that his client cannot create a spendthrift trust for his own benefit.

In Texas, as in many states, the cash value of life insurance is immune from the claims of the insured’s creditors after it has been in force for two years unless the policy was purchased in fraud of creditors, provided that the policy is payable to a named beneficiary.18 The death benefits in the hands of the beneficiary are like-

wise not subject to attack by the insured's creditors. Furthermore, even a revocable insurance trust falls within the category of a named beneficiary. This fact alone will often warrant the establishment of a life insurance trust rather than payment to the insured's estate, where the entire proceeds will be subject to every claim against the decedent.

Not only are the cash surrender value (and therefore the policy itself) and the death benefits free from the claims of the creditors of the insured, but the Texas statutes also specify that the creditors of the named beneficiaries cannot attach the proceeds when they are payable in installments. Moreover, the Texas courts, apparently reluctant to be outdone by the legislature, have held that a lump sum payment to a widow of the proceeds of life insurance on her husband's life is exempt from the claims of the community creditors. The theoretical basis for this holding is that such proceeds are the widow's separate property, and a wife's separate property is not subject to community debts. The contrary holding should be reached if the husband receives the proceeds of insurance on his wife's life since his separate property is subject to community debts. If the proceeds are payable to a trust, the trust agreement itself can, in Texas and in other states which recognize spendthrift trusts, contain appropriate spendthrift provisions preventing encroachment by the creditors of any beneficiary.

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No other property (except the homestead) is as favored as life insurance, and every estate planner should consider this precious privilege carefully.

F. Life Tax Primer

Appropriate employment of life insurance in an estate plan requires at least a minimum knowledge of the tax consequences attributable to the ownership, use and transmission of life insurance. It is impossible to examine all of the special arrangements which the fertile minds of life underwriters have conceived, but the basic rules are easy to understand.

19 Kerens Nat'l Bank v. Stockton, 120 Tex. 546, 40 S.W.2d 7 (1931).
21 This appears inevitably to follow from the holding of the court in Davis v. Magnolia Petroleum Co., 134 S.W.2d 1042 (Tex. Com. App. 1940).
23 Even though the client may not be peculiarly vulnerable to the claims of contractual creditors, unexpected tort liabilities can nevertheless arise at any moment.
1. Income Taxes

Except in unusual circumstances the payment of the premium has no income tax consequence other than to establish basis, and it can generally be said that premiums are not deductible for income tax purposes. As a corollary, the income increment in the policy, i.e., the amount which is being earned by the investment features, is not taxable income, at least until it is realized in cash. Furthermore, the dividends which are received on participating policies are not income to the recipient because they amount to nothing more than a reduction of premiums. This is sound, because premiums on participating insurance are calculated to give the insurer ample margin within which to pay such dividends, i.e., they represent merely an initial overcharge.

On the other hand, if the insured “cashes out his policy” during his lifetime and takes the proceeds in a lump sum, he will be required to include in his taxable income the difference between the amount collected and the net premiums (or the consideration) paid therefor. However, the impact of this tax can be mitigated in two ways. First, the tax to be paid will never be more than it would have been had the profit been included in the taxpayer's income in three equal portions realized in the tax year in which the proceeds were received and in the two preceding years. Second, if the policy, such as an endowment, has a maturity date, the owner of the contract has sixty days from the date on which it matures to avoid the income tax result of a lump sum payment by electing to receive an annuity, in which event the owner will be taxed in installments on an annuity basis.

Under the 1954 Code, installment payments of all types are taxed in an identical fashion. In its simplest form the rule established by the 1954 Code attempts to evaluate what portion of each installment payment is a return of capital and to exempt this portion from taxation. For example, if the cost of an annuity is $10,000 and the owner of the contract is to receive $1,100 per year for a period of ten years, then the cost is divided by ten so that $1,000 of each annual payment is excluded from income as a return of capital, and the balance of $100 is included as ordinary income.

The same technique is used in determining the excludable portion

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26 Int. Rev. Code of 1954, § 72. The rule is for convenience only and is not logical in a strict sense, because obviously each successive payment consists of proportionately less income and more principal than the preceding payment.
of a life annuity, except that the period over which it will be payable is arbitrarily figured as the life expectancy of the annuitant. After the annual amount to be excluded as a return of principal has originally been computed, this amount is always deductible even though the annuitant may live far beyond his statistical life expectancy.26

Death proceeds are treated quite differently from lifetime payments, possibly because Congress has been unwilling to assume that the purchase of life insurance is really a transaction entered into for profit under normal circumstances, involving as it does the death of a loved one.27 Whatever the explanation, as a correlative of the fact that premiums are not deductible, death proceeds payable in a lump sum are normally not taxable income.28 However, if the policy has been transferred for a valuable consideration, it has entered the market place as a commercial transaction. Thereafter, any death proceeds are subject to income tax to the extent that they exceed the original consideration plus all subsequent premiums and other amounts paid by the transferee less other amounts such as dividends received by the transferee. The exceptions to this transfer for value rule are fully as important as the rule itself. Transfers to the insured, to a partner of the insured, to a partnership of which the insured is a partner, or to a corporation in which the insured is a shareholder or an officer, even though for value, do not render the proceeds taxable to the transferee.29 A gift obviously is not a transfer for value, and, therefore, the general rule of non-taxability is not altered by donative transfers.

Although lump sum payments of death proceeds are not taxable as income, income earned after death by virtue of the insurance company’s retaining the proceeds under one or more of the options is taxable. For example, the interest paid by the insurer on a policy held under the interest-only option is ordinary income taxable to the recipient. If the death proceeds are retained and paid on an installment basis so that each installment contains elements of both principal and income, the recipient is taxed under the annuity rule previously explained. For this purpose the cost of the policy in the

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26 If the annuity is measured by more than one life, joint and survivor annuity tables are used to calculate the portion to be excluded each year.

27 A more logical (and less sentimental) explanation is that unrealized profit in most other investments retained until the death of the owner may also escape the income tax entirely. The Treasury is, however, interested in this entire field.


29 There is an additional exception if the transferee’s basis is determined in whole or in part by reference to the basis of the policy in the hands of the transferor, such as a policy received in a tax-free reorganization; provided, of course, that the proceeds would have been exempt from income tax in the hands of the transferor.
hands of the beneficiary is considered to be the lump sum payable at death. The surviving spouse of the insured who is a beneficiary of his life insurance under an installment option has a special dispensation and can exclude $1,000 per year of the income which would be taxable to any other person under the annuity rule. In effect, this means that a quite substantial monthly insurance benefit can be received by a widow tax free on the basis of this special exclusion plus a return of principal. The significance of these figures is diluted, however, by reason of the low return on an insurance policy. Thus, the use of this arrangement for tax reasons alone should probably be confined to spouses who would be in a high income tax bracket without the insurance.

2. Special Income Tax Rules

There are a few special situations which should be considered because they are so frequently encountered in the sale of life insurance. An ordinary taxpayer is able to deduct all of the interest he pays on his own indebtedness. Section 264 of the 1954 Code contains an exception to that general rule denying the interest deduction for interest paid on loans incurred to purchase a single premium life insurance contract. A single premium contract is defined as a policy in which substantially all of the premiums are paid within a period of four years from the purchase date of the contract or on which a substantial number of premiums are paid in advance. It is obvious that most policies do not meet this definition. Several contracts have been especially designed to afford high initial cash values without becoming subject to Section 264. This cash value permits the insured to borrow a large part of each premium, thus in effect converting a substantial portion of each ordinarily non-deductible premium payment into a fully deductible interest payment.

The taxation of that portion of the income of a living trust which is used to purchase insurance on the settlor's life is of peculiar interest to the estate planner. Section 677 of the 1954 Code provides that the

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21 If a woman is sixty-five at the date of her husband's death and has income derived solely from payments under life insurance policies on his life, she can receive over $900 per month without payment of any income tax because of the combination of her double personal exemption plus the $1,000 special exclusion.
22 The essence of this arrangement is that the income increment within the policy is not taxable to the insured, whereas the interest is deductible. It is demonstrable that (forgetting commissions, loading, etc.) if the cash values within the policy bear interest at a rate of 2½% and the insured can borrow at 5% (which is usually guaranteed in such specially tailored policies), and if the insured's top income tax bracket is greater than 50%, he can make money on this arrangement, provided he never surrenders the policy in such a manner that he becomes taxable on the internal income increment.
settlor will be taxable on the income of a trust created by him to the extent that such income is applied to the payment of premiums on policies of insurance on his life without the approval or consent of an adverse party, even though the trustee purchasing such life insurance may be completely independent of the grantor. It will be noted that this rule is applicable only to insurance on the life of the settlor, and in appropriate cases trusts may own and pay for life insurance on the life of a non-settlor without untoward tax results.

We discuss the so-called "split-dollar" plan under the heading of income taxes because one of its uses is to supplement the income of a highly paid executive without taxing the benefits to him as compensation. Certain life insurance policies are specially designed to provide high cash values. Such policies are purchased by a high bracket executive on his own life, and his employer, normally a corporation, lends him interest free an amount equal to the increase in cash value. The employee pays the entire premium, of course, but his only real expense is the difference between the increase in cash value and the gross premium; ultimately this difference disappears entirely as the earnings within the policy increase. The employer is assigned the cash value as security for its loan to the employee, and upon the death of the employee, the employer receives out of the proceeds full payment of its loan. Thus, the employer is completely secured at all times and is out nothing except loss of return on its money. The employee's beneficiary receives the balance of the proceeds. Because of the increasing cash value and the increasing amount pledged to the employer to discharge the employee's debt, the amount payable to the employee's beneficiary could be expected to decrease each year. However, in order to enable the employee to rely on a specific sum being paid to his family on his death, these special policies usually provide either directly or through a term rider for a sufficient amount of term insurance (or paid-up additions) so that the difference between the proceeds and the cash value is a constant sum. The essence of this split-dollar plan, of course, is that the employee has received interest free use of the employer's money during the life of the policy. However, the value of this benefit can be very substantial to a high bracket executive. Of course, interest free use of money would be valuable without insurance, but the use of insurance provides the employer absolute security and also provides some tax free internal increment to the employee.\[23\]

\[23\] Nor is the employer-employee relationship necessary to such an arrangement. A father may lend his son interest-free money secured by the cash value of life insurance.
Needless to say, the plan should not be used in any event unless the employee needs the insurance.

Numerous "gimmicks" have been popular from time to time, but usually have faded out either because of judicial disapproval of these "you thought you were smart" plans or because of loop-hole plugging by Congress. Others have died because they presented nothing for the insured and were chiefly a method of increasing the agent's commission (and worse, in some cases an attorney's fee). A discussion of these arrangements is beyond the scope of this paper, but an attorney should watch for them and should be aware of their pitfalls so that he can have some idea of how to explain to his client why they should be eschewed. Even though the client's golfing buddy's tax adviser has approved the arrangement and no untoward event has yet occurred, this is no reason to jeopardize one's client.\(^4\)

3. Estate Tax

The Federal estate tax problems in relation to life insurance are simpler than the income tax problems. If the estate of the deceased is the beneficiary of life insurance on his life, the proceeds are includable in the gross estate for estate tax purposes regardless of who holds the incidents of ownership. On the other hand, insurance payable to a beneficiary other than the insured's estate is includable only if the insured holds one or more of the incidents of ownership at the time of his death or if, in the case of certain transfers, the insured holds a reversionary interest therein valued at more than five per cent immediately prior to his death.\(^5\) If insurance is owned by a trust whose corpus is taxable to the insured, the insurance will be taxable in the estate of the insured like any other trust property. Furthermore, the usual hazard as to gifts in contemplation of death may also render the proceeds of a policy given away taxable in the estate of the insured if the insured thoughtlessly dies within three years after the gift. Since insurance has a peculiarly testamentary taint arising out of the very "nature of the beast," a gift of insurance is more likely to be held to have been made in contemplation of death than would a gift of other property.

One should not overlook the fact that the value of insurance on the life of some third person which is owned by a decedent is taxable in the estate of the decedent like any other property owned by him.\(^6\)

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\(^4\) For an example of one such unsuccessful arrangement, see Knetsch v. United States, 364 U.S. 361 (1960).


\(^6\) The value will be based upon the sales price of a comparable policy at the time of
4. Inheritance Tax

Needless to say, the inheritance tax provisions of the various states differ widely in their treatment of life insurance, but in general it is safe to state that insurance is subject to inheritance tax (or estate tax) by the various states along the lines of the federal estate tax treatment. However, a large number of states have preserved the now discarded federal rule exempting from tax a specified amount of insurance (usually $40,000) payable to named beneficiaries. In many states, including Texas, the term “named beneficiary” includes a living trust created by the insured even if the trust is completely revocable by the insured and even if it is unfunded.

5. Gift Taxes

Since the enactment of the 1954 Code, insurance may be given away like other property without unexpected tax consequences, except possibly the increased risk from its inherent susceptibility to attack as in contemplation of death. There is some question as to whether or not the gift of an insurance policy (or the payment of premiums thereon) is a gift of a present interest which is entitled to the $3,000 annual gift tax exclusion, but it is almost certain that the present interest problem will not prove troublesome if the donee is an adult. Even if the donee is a minor, proper handling (perhaps by appointment of a guardian) should solve this problem. Needless to say, in order to make a gift which is effective for estate tax purposes, the insured must rid himself of all the incidents of ownership. However, since the federal estate tax and gift tax laws are not in all respects necessarily parallel, it is possible to make a gift which will be a completed gift subjecting the donor to gift tax liability without removing the policy from his estate for estate tax purposes. This can easily be avoided.

If the insured donor continues to pay premiums on a transferred death, i.e., the “replacement cost.” However, for non paid-up policies it is impossible to ascertain the replacement cost; therefore, an approximation is allowed, based on the “interpolated terminal reserve,” an amount usually a little in excess of the cash surrender value.

The treatment is completely sound. In the first place, any beneficiary designation is revocable, and, in the second place, designation of a revocable living trust is no more than a way of designating as the beneficiaries of the policy the \textit{cestui que trustent} of the trust with an increased element of flexibility. In other words, such a trust is frequently the most effective type of family arrangement and, therefore, comes squarely within the rationale of the exemption, namely that insurance is a preferred method of providing for one’s family.

For example, if the insured retains a 10% reversionary interest in the policy, he will find himself in the position of paying a gift tax on ninety per cent of its value, even though the entire policy is still taxable in his estate by reason of his reversionary interest being in excess of the 5% allowed by Int. Rev. Code of 1954, § 2042.
policy after the original gift of the policy has been completed, each premium payment will be an additional gift to the owner. Such premium payments in the last three years prior to the donor's death may well subject either a pro rata part of the proceeds or a sum equal to the last three years' payments to federal estate tax in the donor's estate unless the payments can be proved not to have been made in contemplation of death.

G. Community Property Rules

Since most of our readers will probably live in community property states, we should mention briefly a few of the community property rules. Probably any policy purchased by an insured prior to his marriage is his separate property. Yet if premiums are paid with community funds after marriage, the community estate probably has a claim for reimbursement of an amount equal to the premiums paid with community funds, or it can be argued that a pro rata portion of the proceeds is community property. Policies purchased after marriage are presumed to be community property, subject to rebuttal upon a showing that they were purchased with separate funds. Because in Texas not only the personal earnings of both spouses but also all income, even from separate property (with a few exceptions), is community income, it is quite difficult to find a reasonable source of separate funds to use in paying premiums, if this is desirable.

Contrary to the rule in several other community property states, Texas not only permits the husband to manage the community, including life insurance, but also permits him to designate a beneficiary of the entire proceeds, at least on his own life, provided that such a designation is not made in fraud of the wife's rights. Insurance is therefore the only property which the husband can freely control until his death and then at death dispose of in such fashion as to defeat the wife's rights therein.

We have used the term property advisedly, although until recently the Texas cases indicated that life insurance either was not property or was not community property or was not community property part of the time. The position of the Texas Supreme Court, however, induced the legislature to reverse the courts, which it may

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41 See Warthan v. Haynes, 155 Tex. 413, 288 S.W.2d 481 (1956); Huie, Community Property Laws as Applied to Life Insurance, 17 Texas L. Rev. 121 (1939); 18 Texas L. Rev. 121 (1940); and Stephens, Life Insurance and Community Property in Texas—Revisited, 10 Sw. L.J. 343 (1956).
have done by amending Article 23 of Texas Revised Civil Statutes to include life insurance specifically in the definition of property.

The federal courts have never fully accepted the anomalous Texas rules (if such rules exist) for tax purposes. Holding squarely that the wife owns half of a community policy, they state that she is subject to a gift tax when the husband dies having designated a third party beneficiary—this despite the fact that she may actually disapprove violently of the named beneficiary, but cannot upset the arrangement because it is not in "fraud" of her rights. Conversely, the Internal Revenue Service holds that only one-half of the proceeds of any life insurance is includable in the deceased husband's estate, even though his designation controls the disposition of the entire proceeds of the policy.

If the community owns insurance on the life of the surviving spouse, then one-half of the cash surrender value as of the date of death constitutes an asset in the estate of the deceased spouse. The estate will presumably have the right to recover at least one-half of the cash surrender value from the survivor—and possibly even one-half of the policy itself.\footnote{Volunteer State Life Ins. Co. v. Hardin, 145 Tex. 245, 197 S.W.2d 105 (1946).}

II. PLANNING THE LIFE INSURANCE ESTATE

A. Purposes Of Life Insurance

There are three principal purposes of life insurance. One of these is investment. We do not normally consider insurance to be a prime subject for investment, because the guaranteed rate of return is small and the loading charges, such as agent's commissions and home office overhead, are substantial. However, it does have a place in some investment portfolios, particularly for an individual who requires a fixed rate of return or who needs a "forced savings" program.

The second purpose of insurance is to furnish a source of funds for the support of the insured's family at the very moment when those funds are most needed, \textit{viz.}, at the death of the bread winner. Life insurance has no peer for this purpose since it is a guaranteed fund which is available in full at the moment of death, even a death which occurs prematurely and unexpectedly.

Lastly, insurance can be purchased to provide a source of funds for the payment of the obligations of the deceased insured, primarily debts and taxes. Every thoughtful plan starts with a careful computation of the aggregate foreseeable obligations of the client to
determine their extent and whether or not they should be covered by insurance. Of course, separation of the three purposes into distinct categories is arbitrary because as a practical matter the three will nearly always overlap to a certain extent. However, a program designed entirely around term insurance will have no substantial investment function unless and until the term insurance is converted into a permanent form.

B. Calculation Of The Need

To say that the estate planner can compute accurately the various cash requirements of the insured is a gross misstatement, because in most instances calculation of the need over a period of time is at best an educated guess. Furthermore, if the client is insurable, he is unlikely to die for a number of years, and accordingly, the needs at the date of death may well differ markedly from current requirements. However, the fact that the estate planner is not prescient should not prevent him from making an attempt to estimate the needs.

Family requirements may be approached in two different ways. If it is felt that they should be met with insurance proceeds paid in installments under a settlement option, the estate planner analyzes the living standard of the family, the number of people involved, and the unfulfilled objectives (such as education of minor children). He then adds a reasonable amount for contingencies and calculates the insurance necessary to produce the desired monthly income, ignoring for the moment any possible excess earnings.

If, on the other hand, the plan finally chosen envisages meeting the family needs from the investment of insurance proceeds payable in a lump sum, a slightly different approach must be taken. Again, the planner makes an estimate of the family needs, but he must recognize that the investment return, although normally larger than the rate guaranteed by an insurance policy, may vary from year to year. This is true not only because of the change in the rate of return in the market place, but also because the proposed investor may in some cases be an inexperienced widow in contrast to a corporate trust department with a large investment advisory section at its command. This arrangement has a built-in reserve—the principal of the income earning fund—but one should take into con-

43 Again we disclaim any special actuarial knowledge, but it is our understanding that the mortality rate is extremely low in the first five years after purchase of an insurance policy. This seems logical, because the medical examination could be expected to weed out the more serious risks.
sideration both the natural reluctance of the survivor to use corpus and the real possibility of a decline in the amount of the principal."

Obviously, estimates of family requirements must take into consideration other sources of income available to the family. These are likely to fall into three categories. The first is the potential earning power of the expected survivor, normally the widow. This will depend to some degree on her age, on whether she is presently employed, and if not, whether her education is of a type which will enable her to resume work if necessary. For example, if a widow in Texas has a permanent teacher's certificate she can probably obtain a teaching job at any reasonable time, as long as the present shortage of teachers remains acute. The second category is income from property. This may be income from property presently producing income and expected to continue to do so, or it may be income from presently fallow property which can be sold and reinvested in high grade securities. To illustrate the latter possibility, many high income, moderate estate families live in a home which realistically will have to be sold on the death of the husband in favor of a less expensive residence, the excess thus becoming available for investment. However, if such a sale is anticipated, care should be taken to provide sufficient ready funds to avoid a forced sale of the home (both for emotional and economic reasons). The third category, which has become more and more important, is the outside resources which become available only upon the death of the client. These include Social Security benefits, proceeds of pension and profit-sharing plans, and group life insurance maintained by the insured's employer.

Still another source of assistance is the family aid that will be available in many instances, although this is frequently overlooked as a matter of false pride. In its simplest form this help may be donations from either the wife's or the husband's family immediately after the death of the husband, but more likely it will be in the form of potential inheritances from other members of the family. It goes without saying that existing trusts, testamentary or inter vivos, should be carefully considered as a potential source of family revenue.

Paying life insurance premiums is no pleasure, and any money so used will be spent at the expense of other investments or of a presently higher standard of living for the family. No insurance should ever be purchased unless it is absolutely necessary. There-

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44 If regular invasions of principal become necessary, and if the primary beneficiary lives longer than expected, the entire principal may be dissipated.
fore, a family which has a reasonable expectation of substantial inheritance in the future should evaluate those expectations realistically and take them into consideration in buying insurance. An expectancy may prove unfounded, but no other part of estate planning is an exact science either. If such inheritances are estimated conservatively, both as to time of realization and the amount of the inheritance, the estate planner is not taking an undue risk.

A calculation of the funds needed to pay debts and taxes is usually simple. The debts should be estimated realistically, and if the insured is in a business which causes his liabilities to fluctuate substantially, the maximum indebtedness normally should be used in any computation. It is necessary to be realistic also in the evaluation of properties which will be the basis of death taxes, and allowance should be made for probable increases in these values through the years. Furthermore, in estimating death taxes, it should be remembered that any additional insurance purchased, if owned by the insured, will itself be taxable in the estate of the insured. With these points in mind, a reasonable estimate of the amount required to pay debts, taxes and expenses of administration can readily be made. A rough calculation is sufficient. The certainty of the amounts set out in some projections or estate plans prepared under many of the so-called "estate planning" systems is in itself a snare and a delusion.

The provision of a ready fund of cash for the payment of debts and taxes is one of the chief selling features of life insurance, but the estate planner should always bear in mind there are other satisfactory methods of raising money. Property may be sold, and often there is property that not only can be, but should be, sold in the event the income producing member of the family dies. For example, certain types of country places, which are not too expensive as long as the maintenance costs are charged against taxable income, may be a luxury which the decedent's family (even though wealthy) can ill afford both because of heavy expenses and lack of income from the property.

Another source of funds with which to pay estate obligations, particularly taxes, is borrowed money. At first glance this may sound like a contradiction in terms, but it is not, particularly if the executor (and trustee) of the deceased's estate is a person enjoy-

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45 The theory that an estate will never want to sell assets and that the purchase of insurance will prevent such sales is not always sound. It often holds true if the insured dies prematurely but is more likely to be completely erroneous if he lives a normal life span. In the latter event, the purchase of life insurance in itself can be likened to an advance (but orderly) sale of properties, i.e., a failure to make investment in favor of paying premiums.
ing the respect of the lending institution. Moreover, by the use of accumulat­ing trusts and by splitting the estate income among several taxpayers, such as the estate and one or more testamentary trusts, the after-tax income available to amortize loans obtained for the payment of taxes and other obligations may even be greater after the decedent's death than during his lifetime.

Still a third source of funds other than life insurance for an estate may be an irrevocable living trust created by the client (or even by a third party). Such a trust will have not only its original corpus but in Texas may accumulate income. Such accumulations will probably be taxed at a much lower rate than the same income in the hands of the client. The effect is that a substantial fund can be built up in such an inter vivos trust partly out of income tax savings, and this fund can be used either to lend money to the decedent's estate or to purchase assets from it. An added bonus is the decrease in death taxes resulting from gifts to the trust. If the insured survives for a period even closely approximating his expected life span, the accumulated increase (not to mention growth) in a well-managed trust of this type should substantially exceed the proceeds of all of the insurance which the deceased could possibly have purchased with the same amount of income reduced by income tax.

There are several statutory dispensations which should not be overlooked in determining the cash fund necessary at death. One variant of the outright sale of corporate stock is to have part of the deceased's stock in a closely held corporation redeemed, and if the requirements of Section 303 of the 1954 Code are met the redemption will be free of the taxable dividend danger. Furthermore, if a closely held business, incorporated or unincorporated, constitutes more than thirty-five per cent of the gross estate of the deceased or more than fifty per cent of his net estate, that portion of the estate taxes attributable to the business interest may, in a sense, be borrowed from Uncle Sam himself by payment in installments over a period of ten years at a four per cent interest rate, a real bargain.  

C. How To Pay Premiums

The old fashioned way of paying premiums (and possibly still

46 Int. Rev. Code of 1954, § 6166. Occasionally, careful planning will permit the use of these redemption and installment payment devices when otherwise they would not be available. For example, purchasing insurance as a corporate asset rather than as a personal asset may well make the difference in whether the eligibility tests can be met. Reference should also be made here to Rev. Rul. 61-55, 1961 Int. Rev. Bull. No. 13, at 16, in which ownership of working interests is held to qualify as a "business" for purposes of § 6166, but ownership of royalties is not.
the best way of doing so) is to hand the insurance company the cash remaining after the insured has paid his income taxes and has met the bills for the necessities of life. However, this method has its limitations. Let us assume that a young executive, age forty, needs $500,000 of insurance to pay his debts and taxes and still leave enough to support the members of his family in half as luxurious a style as that to which they have become accustomed. Ordinary life insurance at his age in the face amount of $500,000 will cost approximately $12,000 annually, and our present income tax structure will not permit him to maintain his standard of living and still have enough after-tax dollars to purchase this much insurance. Of course, it is possible to liquidate investments and to make such payments out of principal, but most clients are reluctant to follow this course because insurance is not a sufficiently satisfactory investment to justify liquidation of valuable properties. So we would probably advise him to purchase a smaller amount of insurance and "try not to die." Even if we did advise him to purchase this much insurance, he would probably, nonetheless, disregard our advice.

In other words, our hypothetical client will find himself seeking some alternative, either in the field of life insurance or through other methods, such as reducing his taxable estate by gifts, reducing his income tax by the purchase of tax-free municipal bonds, or investing in growth stocks. Let us assume, however, that no other alternative but the purchase of life insurance is open, and, therefore, he wishes to explore other methods of buying insurance. He may, of course, buy some form of term insurance, which will temporarily be much less costly than ordinary life (perhaps $5,000 as compared to $12,000 per year), but at some age, term insurance loses its attractiveness, and our man is approaching that time of life.

1. Borrowed Funds on Minimum Deposit

In seeking a more attractive method of paying premiums, the estate planner may suggest a "minimum deposit" plan. The mechanics of this plan call for the purchase of an ordinary life policy (usually a specially designed policy with "beefed up" cash values) and for the insured to borrow either from a bank or from the insurance company an amount approximating the cash values. Since such a policy usually provides high cash values and a relatively low maximum rate of interest, the out of pocket cost is relatively low. In later years, as the increasing size of the loan causes the interest to increase, the insured will, nevertheless, find a steadily diminishing net cost to himself because (1) the internal earnings increment
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is steadily increasing, and (2) the interest paid is deductible by the client for income tax purposes. The essence of the plan is that the interest paid by the insured is deductible while the return being earned by the policy cash values is free of income tax. Thus it is demonstrable that a client in the fifty per cent income tax bracket can purchase permanent insurance in this manner at a lower net cost than he would pay for term insurance. The primary objection to the plan is that the amount of actual insurance (the difference between the face amount of the policy and the cash value which has been borrowed each year) is steadily decreasing. Policies are available with arrangements to offset this decrease so that the face amount payable on death is constant, but, of course, such an added feature represents more insurance and thus increases the cost.

2. Corporate Assistance

Another method of paying the premiums at a minimum cost to the executive is to seek assistance from his corporate employer. Let us assume that the client is not a controlling stockholder of the corporation and is not concerned with possible "bias" either on the part of the corporation itself or on the part of the other stockholders. Therefore any arrangement made by the corporation for his benefit will actually be additional compensation to him, although it may not be taxable as such.

For example, the employer may have a group life insurance plan, and the young executive, as one of the management team, may be furnished, tax free, a substantial amount of such insurance. This is a "fringe benefit" on which the executive pays no income tax, but since he will almost certainly possess one or more of the incidents of ownership of the insurance (at least the right to designate the beneficiary) the proceeds of the policy will be part of his gross estate for federal estate tax purposes. In most cases such group insurance, though very helpful, falls far short of the total need.

The corporation may also combine straight insurance, probably ordinary life, which it purchases for "key man" purposes (to compensate the employer for the loss of a valued employee), with an additional amount which it may pay to the executive's widow either under a contractual arrangement or from love and affection. Any such payment may be taxable income to the widow. An exemption exists as to the first $5,000. It is the position of the Internal Revenue Service that any amount in excess of that figure is taxable income. Some taxpayers have litigated the question and succeeded in establishing voluntary payments as non-taxable gifts. United States v. Kasynski, 284 F.2d 143 (10th Cir. 1960); United States v. Reed, 177 F. Supp. 201 (W.D. Ky. 1959), aff'd, 277 F.2d 456 (6th Cir. 1960); Martin v. Commissioner, 36 T.C. No. 56 (1961); Pierpont v. Commissioner, 35 T.C. No. 10
will be included in the employee's estate for estate tax purposes if the corporation is contractually obligated to make the payment. While such payments to the widow may be funded (or unfunded) in any way the corporation chooses, life insurance does provide a convenient method of providing for the widow whether or not the payments are made pursuant to a binding contractual obligation.

As another avenue of assistance from his employer, the executive may be able to induce the corporation to enter into a "split-dollar" plan, in lieu of his next raise. As discussed previously, this plan really amounts to an interest-free loan by the employer to the employee of an amount sufficient to cover most of the premium cost. The net effect of any borrowing arrangement to the insured is decreasing term insurance, but it is cheap insurance and enables the executive to have much better coverage than is otherwise possible. Policies designed for this arrangement usually contain some type of term or other rider which guarantees that the executive's beneficiary will receive an amount equal to the face value of the policy. This means that such supplemental benefits are sufficient in amount at any time to equal the cash values which will be paid to the corporation to discharge its loan. Of course, as with the minimum deposit plan, such a rider increases the cost to the executive.

3. Use of a Trust

Another method which may be available to the executive to meet his premiums is the utilization of a trust. This may be a testamentary trust created under the will of one of the parents of the executive or his wife, or a living trust established by some member of the family for the benefit of the executive's wife and children (and, possibly for the executive himself). In the latter case, insurance owned by the trust will either directly fund his family obligations or be available for loans to (or purchases from) his estate to satisfy its liquidity requirements. Such a trust may be a useful vehicle for purchasing part or all the insurance on his life. To accomplish this, the trust must specifically authorize the trustee to purchase life insurance. If the trust has its situs in a jurisdiction which allows the accumulation of income for adult beneficiaries (and its effectiveness for our purposes will be slight if this is not so), the trust will probably be in a lower income tax bracket than the executive and after taxes will have a greater income from equivalent investments with which to pay premiums. As an example, assume an existing

(1960). Others have failed. The trend is apparently running against the taxpayer in this area since the decision in Commissioner v. Duberstein, 363 U.S. 278 (1960).

48 See 3 Scott, Trusts 1676, 1699 (2d ed. 1956).
trust in which income can be accumulated or paid to the young executive, his wife or any of his descendants, and assume that the annual income of the trust is about $7,500. If the entire income were distributed to our forty-year old executive in the sixty per cent income tax bracket, he would retain some $3,000 after taxes, and with this sum he could purchase slightly over $100,000 of ordinary life insurance. On the other hand, the trust itself would pay taxes and fees of only $2,300, leaving a net income of about $5,200, to be applied to premiums, which would purchase approximately $200,000 of ordinary life insurance. To provide an adequate margin of safety, we might let the trust buy only $150,000 of life insurance, reinvesting the balance of the income. As a special dividend, the proceeds of the insurance thus purchased by the trust will be free of the federal estate tax, assuming, of course, an appropriately drafted trust agreement.

Even though existing trusts may be unavailable, it is possible to create new trusts to perform the same function. The executive’s parents or other relatives may establish trusts for this purpose. His wife may also create such a trust if she owns separate property, or she may even use her half of community property which has been partitioned under Article 4625 (a) of Texas Revised Civil Statutes. The disadvantage of having the wife act as the settlor is that she cannot be a beneficiary of the trust, except at the risk of having the trust income taxed to her, a self-defeating maneuver. She might, however, employ a short term trust, specifying that the corpus will revert to her at the time of her husband’s death (when her need is greatest) and that the accumulated income, including the insurance proceeds, will at the same time either be distributed to the children or retained in trust for their benefit. This will prevent her being taxed on the current income. The executive cannot use his own property to fund a trust to carry life insurance on his life because of the proscriptions found in Section 677 of the 1954 Code discussed above. He can, of course, use his property to create a trust which purchases life insurance on his wife’s life, provided there is no inference that separate trusts created by his wife and himself were in fact cross trusts, and therefore, each is the grantor of the trust carrying the insurance on his own life.49

D. Selecting The Type Of Insurance

Selection of the type of insurance to recommend is partly a matter of personal preference, but mainly a matter of evaluating

various conflicting factors, such as the insured's ability to pay premiums, whether the need is temporary or permanent, the possibility of changes in circumstances, and the insured's income tax position. Some of the plans previously mentioned themselves dictate the type of policy to be used. For example, the split-dollar and minimum deposit plans both require the use of ordinary life or some other type of policy with growing cash values.

For the young husband and father with a limited income, the only insurance to be considered for maximum protection is term, with the keeping in mind that any part of the insurance which ought to become permanent may later be converted. Term insurance will not only provide a ready cash reserve in the event of death, but to a certain extent will "insure the insurability" of the young husband at some future date when he will need to carry a larger amount of permanent insurance than is now justified (or feasible). Furthermore, some of the initial needs that govern the amount of insurance will disappear with the passage of time. Assume that the young father has three children ranging in age from twelve to six. Actually, ten years from today some of his burdens will have diminished, because the eldest child will have completed his education, and five years later presumably all of the children will have finished college, leaving as his only family obligation the support of his wife. At that time her gross lifetime needs will have decreased, since her life expectancy is less. However, realistically it must be recognized that fifteen years from now her standard of living may well have increased and her ability to earn a living may have dropped to such an extent that total requirements for family insurance may be no less than today.

While it may seem cold-blooded to estimate anticipated inheritances from older generations, nevertheless, any estate planner who does not do so makes a mistake. If, for example, our hypothetical husband's own father has died and has left his mother an estate of approximately $500,000, we should certainly consider the possibility of her establishing a living trust for the benefit of his family and for the purpose of purchasing insurance on his life. If the mother is eighty-five years old, we would be foolish not to assume that within fifteen years our client will have inherited part or all of her estate. Of course, the inheritance may increase his need for insurance if no estate planning has been done for his mother, since he may have to pay taxes on the residue of her estate. However, if sound planning has been completed for both generations, there is no reason to assume that his estate tax burden will be augmented by an out-
right inheritance from her. Furthermore, if by any chance the old lady dies earlier (without an application of arsenic), testamentary trusts under her will may well be able to assume part or all of the burden of his life insurance or may even solve so many of his financial problems that no insurance is desirable.

These fact situations, one presenting a prospective reduction in the obligations to be satisfied by insurance, and the other a prospective increase in properties which can replace the insurance, both of which are reasonably certain to eventuate within a limited period of time, indicate a need for a temporary form of insurance only. Even if our predictions are erroneous and the client must later convert his term insurance to a permanent form, he has still “insured” his ability to obtain permanent insurance when it is required. Naturally, if the need is permanent, ordinary life is preferable, provided the client can afford to purchase it. The converse of that proposition is equally valid—if the need is temporary do not purchase permanent insurance. Accordingly, the planner should calculate the need, make the best guess as to its permanence and, if permanent, then obtain a permanent form of insurance within the premium paying abilities of the client.

We will not discuss what is euphemistically called the “higher type” of insurance, such as annuities, endowments, or twenty-pay life. In purchasing these contracts one has left the field of life insurance and entered the wasteland of investment; without being derogatory to life insurance, there are in our opinion better investments (such as life insurance stocks). However, we do occasionally encounter a spendthrift, and if the wastrel possesses large quantities of cash, we may recommend one of these policies or even single premium life insurance, feeling that at least the money will be available when it is needed in the future.\footnote{Other devices, such as the establishment of a spendthrift trust for members of his family, may be more effective.} Also, as mentioned previously, there are certain people who must be forced to save, and the “obligation” to pay life insurance premiums regularly may be the required goad; if the need in such cases is primarily for investment and not for insurance (usually a doubtful proposition), then any of the “higher type” policies may be acceptable.

E. Who Should Be The Beneficiary And How Should Proceeds Be Paid

1. Wife as Beneficiary

The insured’s first thought as to a beneficiary is usually his wife, with payments in installments or even in a lump sum. In the small
estate, either procedure may be acceptable. There are definite advantages, as a matter of fact, in addition to simplicity in designating the wife as beneficiary. Under the laws of many states there is the special inheritance tax exemption for insurance proceeds payable to a named beneficiary, and the creditors (for example, community creditors in Texas), may be unable to attach either the cash surrender values during the insured's life or the proceeds at his death.

Furthermore, if insurance is payable in installments, it is taxed on an annuity basis, and $1,000 of that portion which would otherwise be taxable income is not taxable to the wife. Accordingly, because of the return of principal and the non-taxability of a portion of the income, the insured's wife may have a substantial monthly income without paying any income tax. Moreover, any installment payments will, until received at any rate, continue to be completely free from the claims of the wife's creditors, either pursuant to a special statutory dispensation or, what is so often forgotten, because of a spendthrift clause which may be incorporated in the settlement agreement with the insurance company.

Installment payments are of particular interest to two contrasting types of widows. The first of these is the widow with an estate so small that she knows she must use principal but would like to be in a situation in which it will never be exhausted. She fears the use of a trust because her longevity may be such that she will completely consume the trust corpus; therefore, some type of life income option is almost mandatory. On the other hand, the wealthy widow, who is in a sufficiently high income tax bracket that both the annuity method of taxation and the $1,000 annual exemption have real significance, may want to select settlement options despite the low rate of return. The wealthy widow should place on installments only the precise amount of insurance necessary to produce exactly $1,000 per year of income (all of which will then be exempt), and the balance of the estate, including any additional insurance, should be stashed away in a trust, preferably of the sprinkling type, which will give complete flexibility to the plan. The widow's budget will probably exceed the monthly installments and so the settlement options will be unlikely to increase her taxable estate to any appreciable extent.

The disadvantages of designating the wife as beneficiary are as apparent as the advantages. In the first place, if insurance is payable in a lump sum or in installments to the wife, then to the extent that those funds have not been consumed by her after her husband's death her estate will be augmented and the total estate tax liability
of the family unity will have increased.\(^8\) However, this result does not follow if the insurance payment is in satisfaction of the marital deduction. Some of the ill effects in other instances may be mitigated by a properly drawn remainder interest contained in the settlement agreement.

A lump sum payment to the wife may also be dangerous from a family standpoint, because a wife who has not previously had substantial amounts of cash and has had little or no investment experience is likely to waste part or all of the insurance proceeds before she realizes the necessity of careful conservation and management of her resources. On the other hand, installment payments present a certain inflexibility which may be undesirable if they are not supplemented by a flexible trust arrangement. It is recognized that special contractual settlement agreements can provide some flexibility, and some insurance companies will, if urged to do so, enter into what amounts to a semi-trust arrangement.\(^8\) However, the most complex of settlement agreements is usually limited to simple discretionary powers, such as an increased withdrawal privilege during periods while children are in school, and they rarely give a disinterested third party the broad discretion which a carefully drafted trust agreement can provide.

The final objection to naming the wife as the beneficiary is that the funds may not be available for the proper purpose at the proper time. If installments are selected and neither the wife nor the insured's executor has the right to demand the proceeds in a lump sum and if liquidity is more desirable than providing income for the wife, we may have failed to achieve our primary objective. Furthermore, the wife is not always cooperative. Particularly in a two-family situation (that is the surviving wife is not the mother of the insured's children), she may choose to "latch onto" her insurance proceeds, caring little for the rest of the family or for the possibility that assets may be sacrificed for want of cash funds. Even the mother of the insured's children may be a highly opinionated and stubborn woman whom it is impossible to convince of the wisdom of lending her funds to the estate.

A welcome compromise solution to the liquidity problem is to place the insurance on the "interest only" option for a limited period.

\(^8\) This is not true to the extent that the marital deduction applies to the insurance proceeds. However, since the marital deduction can never apply to community property, the problem is particularly acute in a community property state.

\(^8\) Illustrations of two such special arrangements may be found in Casner, Estate Planning 292-300 (3d ed. 1961). Most states do not grant insurance companies trust powers but Connecticut and Massachusetts do. The "variable annuity" may change this situation.
perhaps fifteen months, giving the executor the right to withdraw any part or all of the proceeds during this period, and providing that the balance either will (or may at the option of some party) be placed on a life income or other similar settlement. Also, the disadvantage of paying life insurance to the wife, particularly in a lump sum, should not be overstressed, since the proceeds normally will be made available to the estate, thereby increasing the estate's liquidity. The same cooperation is to be expected from other members of the family, such as adult children.

2. Other Individuals as Beneficiaries

Payment of insurance to parties other than the wife has the same general advantages and disadvantages as payment to the wife, although the spouse's special right to exclude $1,000 of income is available to no one else. It should be noted that it is often possible to save State inheritance taxes by using life insurance (rather than other property) to make gifts to non-family members (such as employees, friends or servants) whose normal exemptions are quite small but who will be eligible for the special exclusion available for insurance paid to a named beneficiary.\(^{53}\) Such a designation may, however, impose an unexpected gift tax liability on the surviving spouse.\(^{54}\)

One cannot expect a stranger, particularly one who needs money badly, to lend the proceeds of life insurance to the estate. Thus, when the insurance is payable to a third party, it may be an asset which will be included in the estate for estate tax purposes, thus increasing the funds needed for liquidity but at the same time reducing the liquid funds available to the estate. Some of these ill effects may be avoided by transferring ownership of the policy to the proposed beneficiary.

A special advantage is that payments of life insurance to named beneficiaries are not involved in the estate itself, are paid promptly and avoid the expenses of administration.

3. Estate of Insured as Beneficiary

The insurance policy usually provides that if there is no named beneficiary, or if the named beneficiary or beneficiaries predecease the insured, the proceeds of the policy will be paid to the estate of

\(^{53}\) This results from the fact that in Texas and in some other states the lowest tax rate bracket for non-family legatees can be higher than even the top inheritance tax rate for a wife or child receiving an inheritance of several hundred thousand dollars.

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the insured. Payment directly to the estate is now employed in a large number of plans and has many advantages.

In the first place, the entire proceeds will unequivocally be available to the estate, at least in Texas, if the husband's estate is in administration.\textsuperscript{55} Such funds can then be used for payment of debts and taxes, and for other purposes requiring cash or its equivalent, assuming, of course, that the policy is payable in a lump sum and is not subject to unusual restrictions.

The proceeds can also be used as the principal of one or more testamentary trusts whose establishment will be discussed in other Articles contained in this issue of the \textit{Southwestern Law Journal}. A testamentary trust, if well drafted, may incorporate flexibility to an extent inconceivable with respect to funds left with an insurance company, at least under American practice. For example, a typical "sprinkling" trust can be employed so that income may be accumulated and income or principal distributed to any one or more of a group of people, including, but not limited to, the surviving spouse and the insured's descendants.

Moreover, as compared with any other arrangement for the benefit of the wife, a testamentary trust should result in a more substantial ultimate estate tax savings for her estate. If the proceeds are payable to the wife outright, the size of her estate is automatically increased and in the usual community property situation (as contrasted with appropriate marital deduction arrangements) this is undesirable unless the estates are quite small. Any funds which must be paid to the wife will inevitably either augment her estate or decelerate the rate at which her estate is diminished by consumption of principal.

One of the most serious disadvantages of payment in a lump sum to the estate (a disadvantage the full seriousness of which cannot be adequately appraised at the time of planning) is that they render the entire proceeds vulnerable to attack by creditors of the insured husband (and of the wife as to the community debts) and to the subsequent creditors of the wife or residuary legatee. By contrast, if the proceeds are used to fund a testamentary trust containing adequate spendthrift provisions, they obtain immunity not only from the husband's creditors but also from the wife's creditors (at least as to the husband's one-half of the proceeds of community insurance) and from all creditors of any other beneficiary.

Since one-half of the proceeds of community life insurance payable in a lump sum to the estate belongs to the wife outright, free

\textsuperscript{55} Tex. Prob. Code § 177(b) (1916).
and clear of all trusts, this half of any lump sum payment may be improvidently spent if the wife has no investment ability, listens to poor advice or is a spendthrift. While she may be put to an election as to her community one-half, it is often inadvisable for various reasons to put teeth into an election provision. Furthermore, proceeds payable to the estate will not be entitled to the inheritance tax exemption available only to insurance proceeds passing to a named beneficiary. Lastly, the insurance payable to the estate will be subject to administration as part of the estate and to the extent that fees are calculated on a percentage basis the amount of the insurance will probably increase the fees payable by the estate.

4. Payment to a Testamentary Trustee

Designation of a testamentary trustee as the primary beneficiary has become more common in recent years and is now acceptable to a number of insurance companies despite some technical difficulties. Usually this beneficiary arrangement is coupled with a provision that if no testamentary trust is established within a stated period of time after the death of the insured, the proceeds will be delivered to the executors, administrators, or assigns of the insured, i.e., to his estate. This designation owes its popularity to the thinking of many competent planners that it avoids the disadvantages of naming the estate as the beneficiary. However, it seems doubtful to us that the arrangement circumvents any of the disadvantages previously mentioned. At any rate, there is simply not enough law on the subject to justify more than a semi-educated guess as to the results of such a designation so we suggest some other route since conservative planning avoids not only the unknown but also the half-known.

It is probable that the designation of a testamentary trust as the beneficiary would not avoid the state's taxing the entire proceeds without allowance for any exemption available to insurance payable to a named beneficiary. Also, it is doubtful that this designation would insulate the proceeds from the insured's creditors, even though the courts have been quick to injure the already down-trodden creditor. Moreover, since the courts love widows as much as they detest creditors, it is inconceivable that so simple a device would eliminate the wife's community property rights without her consent, although in the shadow of Warthan v. Haynes, the Texas courts might so hold if the widow were unable to prove fraud. However, when compared with the advantages and certainties of the insurance trust, it seems foolish to venture into the unknown

58 151 Tex. 413, 288 S.W.2d 481 (1956); see note 41 supra.
areas necessarily encountered in making proceeds payable to a
testamentary trust which may never come into existence.

5. Payment to Revocable Insurance Trusts

The insurance trust is the mode of the last decade, and it deserves
its popularity. It has all of the advantages of payment in a lump sum
to the estate and almost none of the disadvantages. Furthermore,
it can easily become a "testamentary trust" if a pour-over will is
used.57

Like all trusts in Texas, none of which are subject to court
supervision or to the requirement of an annual accounting, an in-
surance trust provides relative secrecy with respect to the assets of
the estate. For this reason placing insurance in trust may well be
joined with life-time funding through transferring other assets such
as securities to the trust for management purposes, even though,
being revocable, it has no federal tax benefits. It can furnish all of
the flexibility that could be drafted into any other trust, with the
possible exception that the period for computing the running of
the Rule Against Perpetuities will probably start with the establish-
ment of the revocable trust rather than at the insured's death, as
with a true testamentary trust.

Moreover, if the wife joins in the trust agreement, which should
be required as a matter of legal artistry, and if the provisions of the
instrument are fair to her, the trust provisions probably control her
share of the community property which has been included in it
either as part of the original funding or as a result of paying in-
surance proceeds thereto. We are of the opinion that such a trust
can become irrevocable as to the community property of both spouses
on the death of the husband so that the wife has no right of elec-
tion.58 If our opinion is sound, this prevents the wife's receiving
large sums of cash without any supervision.

An insurance trust can also be a vehicle for other investments,
and it is worth suggesting to the client that he consider funding his
insurance trust (if he is using a corporate trustee) with regular
minimum monthly or quarterly payments under a bank draft type
of arrangement similar to those regularly used in paying life in-

57 See Zuber, Life Insurance Trusts and Gifts of Life Insurance, Texas 8th Inst. on Tax
29 (1960); Beatty, Insurance Proceeds in Trust, 28 Tenn. L. Rev. 344 (1961). See also
Wren, Recent Texas Statutes Affecting Estate Planning, 15 Sw. L.J. 479, 495-98 (1961)
(pour-overs).

58 No case has specifically so stated, but the pattern of case law in Texas with respect
to community property and life insurance seems to us to lead toward this conclusion.
Probably the nearest thing in the cases to a direct statement of this proposition is found
in Commissioner v. Chase Manhattan Bank, 219 F.2d 231 (5th Cir. 1951), cert. denied,
insurance premiums. Arrangements of this type have become more feasible in recent years even if the client has a limited initial ability to fund the trust, since most large banks have established common trust funds permitting profitable administration of smaller accounts.

The disadvantages of insurance trusts are negligible, assuming that the client is willing to accept the trust device. Of course, there are no lifetime income tax savings, with the possible exception of a limited inheritance tax benefit. A second disadvantage is that if the insurance trust becomes irrevocable on the husband's death, the wife will be held to have made a taxable gift of the remainder interest of her one-half of any community property therein. However, there are numerous ways to avoid this gift tax. First, the amount of the gift should be reduced by the value of the life estate she receives in her husband's property in the trust. However, this solution may not be acceptable, since we would prefer a sprinkling trust of the husband's property, thereby intending to obtain not only substantial income tax savings but also estate tax savings through the wife's reduction of her estate by spending all or most of the income attributable to her own property, and even part of her principal, if needed. Gift taxes may be completely avoided by leaving the trust revocable as to the wife's community one-half, but this would defeat our purpose of tying up her property as a protection against possible improvidence. An even more effective device is granting the wife a power of appointment over the remainder interest as to her share of the community property so that no gift will be complete at the time of the husband's death. Such a power of appointment may be general without untoward tax consequences, since the wife's half of the trust will almost certainly be includable in her estate for federal estate tax purposes anyway. On the other hand, the power may be made special and the gift will be incomplete and not subject to a gift tax. Such a special power of appointment need not be broad and may be limited to specific classes such as the wife's issue, spouses of her issue, and

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80 Ibid.
81 Commissioner v. Siegel, 250 F.2d 339 (9th Cir. 1957). But cf. Commissioner v. Chase Manhattan Bank, supra note 58. The government has not conceded that such a reduction is proper. Its position may seem at first blush to have some logical foundation if the wife is powerless to prevent her "gift" and, therefore, cannot have made a "bargain" by exercising an election. But even this seems patently unfair. Certainly, if the wife's acquiescence in the gift, either at the time of placing the policy in trust or at the time of the husband's death, is necessary in order to bind her, then she has in fact made a "bargain," and the value of her taxable gift should be so reduced. Should she be burdened with extra gift tax simply because her "gift" was involuntary (and was therefore not really a gift by her at all in the usual sense of the word)?

qualified charitable organizations. These classes will give her all of the freedom that she really needs and yet will assure her husband that his hard-earned money will not go to unwanted beneficiaries such as the loathesome second husband.\textsuperscript{63}

6. Payment to Irrevocable Trusts

Logically, a discussion of irrevocable trusts should follow revocable trusts. However, an insured rarely designates an irrevocable trust as a beneficiary of life insurance over which he retains the incidents of ownership until his death, since irrevocable trusts are normally established not only for income tax savings but also for estate tax benefits. However, relinquishment of the incidents of ownership is a prerequisite to obtaining such tax results. Furthermore, Section 677 renders trust income which would otherwise be taxable to a trust or its beneficiaries taxable to the grantor of the trust, if and to the extent that such income is used to purchase insurance on the grantor's life. Rarely, therefore, should insurance on the grantor's life be a part of such a trust unless it is a paid-up policy which does not require the payment of further premiums.\textsuperscript{63}

However, if the insurance is on the life of someone other than the grantor of the trust, no undesirable income tax results follow; this fact makes it practical to use the separate property of one spouse (probably the wife) to establish an irrevocable living trust which purchases insurance on the life of the other spouse. When the insured spouse dies, such a trust not only receives tax-free funds but can lend such funds to the estate of the insured without increasing the insured's estate tax base. A trust of this type, which has the power to accumulate income, will probably be in a low income tax bracket and, therefore, will require less taxable income to provide sufficient after-tax funds to purchase the necessary insurance. In Texas, the planner should consider the possibility of partitioning community property, removing the wife's disabilities of coverture, having her use her share of the partitioned property to establish a trust which purchases insurance on the husband's life, and using the husband's one-half of such partitioned property either for other investments or for ordinary living expenses.\textsuperscript{64}

Another useful possibility is to have a trust, either inter vivos or

\textsuperscript{63} Although we have talked about the wife, there are cases where the husband needs equivalent protection if he is the survivor. See text following note 65 infra.

\textsuperscript{64} The discussion below points out the distinct disadvantages of making gifts even of paid-up policies.

\textsuperscript{65} While the Code in § 2056(e)(2)(C) specifically excludes separate property obtained through a partition of community property from the benefits of the marital deduction, it is our opinion that such property is as useful as any other separate property in setting up a trust for the purchase of insurance on the life of her husband.
testamentary, established by one generation for the benefit of one or more younger generations, carry as a part of its assets insurance on the life of members of such younger generation.  

F. Gifts Of Life Insurance

Any treatment of irrevocable trusts raises the often misunderstood subject of gifts of life insurance. The donee may be either an irrevocable trust or some other person, firm, or corporation. The life insurance salesman's rationale in recommending gifts of life insurance (aside from his desire to sell more insurance) is that it produces substantial estate tax benefits. The salesman demonstrates such saving by showing the effect of removing from the estate of the insured the number of dollars represented by the face amount of the policy.

This saving is illusory. Of course, if the insured is careful to die within a short time after purchasing the policy, the salesman's claims are true. However, at this point we must recall that insurance companies and their salesmen make money selling insurance due to the interest income and mortality gains. If an individual is in physical condition to obtain life insurance, then more than likely he will live longer than the statistical life expectancy of a person his age. It is demonstrable that if he lives his life expectancy, gifts of investment properties bearing a normal return will produce much greater tax savings than will gifts of life insurance. In any gift program the estate planner should select carefully the property which is to be the subject of a gift. If the selection is wisely made, and if avoiding estate tax is the primary object of the gifts, property likely to have the greatest appreciation in value should be chosen. Insurance is not in this category unless the insured dies prematurely, whereas real estate or stocks in a growing company may have great possibilities of appreciation so that a small present gift will have removed very substantial assets from the ultimate estate.

Also, the insured-donor is usually in a much higher income tax bracket than the donee, whether the latter is an individual or a trustee. If we assume that the gift program will be limited in extent, then income tax savings can be produced by giving higher return assets such as investment caliber stock or income-producing real property instead of insurance, which need not be given away,

45 In such an arrangement, however, the insured under the policy or policies should normally not be a trustee (or at least should be no more than a co-trustee without any power over the insurance) because of the danger that his powers in that capacity may be construed as "incidents of ownership" whether or not he is a beneficiary under the trust. See Treas. Reg. § 20.2042-1 (c) (4) (1961).
because its income increment is not taxable to the insured and, if paid in the form of death benefits, will not be taxable to the beneficiary as income unless it has been transferred for value.

Therefore, careful planning will frequently result in a decision that insurance is not the proper subject of a gift as compared with other valuable assets. This conclusion may be reached even without considering such factors as the statutory provision that insurance policies made payable to a named beneficiary are not subject to the claims of the insured's creditors—a factor which may render insurance the most important single asset owned by the insured if he suffers economic reversals.

G. Business Life Insurance

Business life insurance is beyond the scope of this Article simply because its ramifications are sufficiently complex to require more pages than are available to us. The reader will be well aware that funding business purchase agreements by life insurance is applicable to any form of business from a sole proprietorship through a corporation. The usual plan involves either cross purchase or stock retirement or "partner retirement" by the corporation or the partnership, as the case may be. We advert to the subject here to call attention to the fact that the existence of business life insurance may well obviate the necessity for personal life insurance, since it can be arranged to satisfy any of the needs mentioned above.

It cannot be reiterated often enough that business purchase agreements have on occasion been badly misused, and it is just as likely in planning that an existing business purchase agreement will have to be revised or abandoned as that a new one will originate. Two principal mistakes are prevalent in business purchase agreements. First, too often an ill-considered plan has denied the family a fine source of income, substituting for a thriving business, cash or its equivalent, which may produce a relatively small return. Second, frequently one is unable to convince the entrepreneur client of the true value of the business and thus prevent him from selling his

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66 The subject has been much discussed, however, and we will cite only a few fairly recent papers. Margolis, Income Tax Aspects of Executive-Stockholder Life Insurance Plans, Gordon, Buying Out the Deceased Co-Adventurer: The Use of Insurance, N.Y.U. 19th Inst. on Fed. Tax 69, 673 (1961); MacKay & Woodward, Corporate Buy and Sell Agreement Forms, Texas 7th Inst. on Tax 177 (1959); Smith, Recent Developments in the Field of Corporate Business Purchase Agreements, 14 Tax L. Rev. 413 (1959). Most of the larger insurance companies and many of those not so large have available material in the form of books or pamphlets containing both text material and forms for use in drafting documents relating to business insurance. It should be borne in mind, however, that most published material on the subject of business life insurance does not take into account the special problems in community property states.
heir’s inheritance for a mere mess of pottage." It is an amusing
sidelight to note how often a client, when asked about the value of
his business for business purchase purposes, will give an absurdly
low figure; however, when questioned about the price he would
demand for the same business currently, he will without a smile
give a puffed-up value that would defy the credulity of a saint.
The estate planner’s hardest job may be to convince him that neither
figure is correct and that a realistic appraisal requires that any sale
at death be so arranged that his family gets a fair price. We are
aware that in some businesses the death of the founder or principal
owner may be a severe blow and reduce the value of the business
substantially. However, we have also observed that in many in-
stances the hardship of such a death is overrated, most frequently,
and perhaps understandably, by the principal owner himself.

H. Marital Deduction

Insurance can qualify for the marital deduction either through
designation of the surviving spouse as the beneficiary of the pro-
cceeds in a lump sum or in installments, provided that she either
has complete and unlimited power of withdrawal or has a general
power of appointment over any unexpected remainder. Of course,
insurance can also be used to supplement other assets in a traditional
marital deduction trust.

We do not propose to discuss the marital deduction in detail,
but two suggestions are pertinent. The first is that most of the
large companies, particularly those whose home offices are situated
outside the community property states, have a number of forms
for settlement agreements designed to take maximum advantage of
the marital deduction. These include such provisions as the nega-
tive common disaster clause, appropriate general powers of appoint-
ment, and other similar techniques that can prove most helpful to
the estate planner. The second is that one should be reasonably
certain that the amount of insurance to be used for the marital de-
duction under settlement options is less than one-half the probable
adjusted gross estate, because it is not easy to arrange a settlement

67 Genesis 21:13. The root of the trouble is that each partner or shareholder, being
an optimistic businessman, is likely to visualize himself as the living purchaser who wants
a low purchase price for the decedent’s interest rather than as the deceased seller whose
estate will be needing the highest possible price.

68 A good discussion of this subject may be found in Casner, Estate Planning 866

69 This raises the ethical question of the size of the fee for using the other man’s
forms; however, as a deceased partner of ours used to say “it would be easy to practice
law if I just knew what the h—— to put in the blanks”; we feel that part of the
task is knowing where to find the forms.
agreement which will use the maximum marital deduction and no more. If this limit is carefully observed and coupled with a formula marital deduction gift or trust in the will of the testator-insured, optimum results may be obtained.

III. Conclusion

We need not reiterate now that our purpose has not been to give an esoteric discussion of life insurance or the intricate federal taxation ramifications applicable to it. As a matter of fact, this has been a purely subjective presentation. Many may disagree with some or all of our opinions. However, we have only attempted to present a few ideas which may be worth considering in attempting to obtain the maximum benefits from life insurance.

The future will no doubt produce fewer Gargantuan estates and more "substantial" estates of upper middle class "folk" who have become accustomed to a most comfortable life. For these families there can be no substitute for life insurance, the only asset which will inevitably be available at the exact time when it is needed. On the other hand, insurance has, in our opinion, often been deliberately misused. Nothing, including life insurance, should be purchased unless there is a real need on the part of the buyer. Such a need may be an actual need or a psychic need, such as the feeling of security engendered by placing a regular monthly check in the hands of a bereaved widow. Once the need is established and the insurance is purchased, careful utilization of the insurance and all other assets in an estate should render the insurance more useful and probably reduce its cost. In our experience, most people need far more insurance protection than they or their insurance advisers ever visualized, but in any event achieving maximum benefits from whatever insurance can be afforded or is available is imperative.