Tax Aspects of Life Insurance Business and Personal Planning

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and Personal Planning

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INTRODUCTION

This article is based on a panel discussion at the Fifth Annual Tax Institute presented in the form of a law office conference involving a "typical case." The form of presentation was felt to be appropriate to the exploration of this particular subject by a group of lawyers. The "typical case" was devised to present not just one problem but a number of inter-related situations in which insurance and tax planning problems may arise in practice. To add to the realism, panel members Messrs. Cavitch, Kidder, and Wolf separately represented and spoke as attorneys for the principal parties in the "typical case." The setting was the "Office of Mr. Sugarman," who for the purpose of this form of presentation, served as a neutral lawyer (and chairman) seeking to lead the discussion through the various competing views and alternative tax and insurance considerations toward possible conclusions and solutions.

FACTUAL BACKGROUND OF ABC COMPANY

The bare facts of the "typical case," around which this presentation centers, are as follows:

The ABC Company is an Ohio corporation engaged in the manufacture and sale of widgets. The company's stockholders, officers, and their compensation are as follows:

<table>
<thead>
<tr>
<th>Shares</th>
<th>Title</th>
<th>Annual Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>400</td>
<td>President</td>
<td>$50,000</td>
</tr>
<tr>
<td>200</td>
<td>Assistant Secretary</td>
<td>$3,000</td>
</tr>
<tr>
<td>300</td>
<td>Vice President</td>
<td>$30,000</td>
</tr>
<tr>
<td>100</td>
<td>Secretary-Treasurer</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

The company's sales have recently reached $2,000,000 a year. Its net profit after taxes last year was $80,000, and it paid $10,000 in dividends. Principal balance sheet items are as follows:
Mr. Able is sixty years old, and his wife is fifty-five. Both are in good health. They have two children. A son, Lester, is an accountant and not connected with the business. Les is married and has two small children. The Able's other child is a daughter who is married to an assistant professor.

Able presently has the following insurance:

<table>
<thead>
<tr>
<th>Policy #1</th>
<th>Policy #2</th>
<th>Policy #3</th>
<th>Policy #4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue date</td>
<td>1927</td>
<td>1928</td>
<td>1932</td>
</tr>
<tr>
<td>Age at issue</td>
<td>25</td>
<td>26</td>
<td>30</td>
</tr>
<tr>
<td>Kind of policy</td>
<td>Ordinary</td>
<td>30 Pay</td>
<td>30 Year</td>
</tr>
<tr>
<td>Face amount</td>
<td>$10,000.</td>
<td>$15,000.</td>
<td>$15,000.</td>
</tr>
<tr>
<td>Cash value</td>
<td>$4,820.</td>
<td>$9,990.</td>
<td>$15,000.</td>
</tr>
<tr>
<td>Annual premium</td>
<td>$165.50</td>
<td>$341.</td>
<td>$395.</td>
</tr>
<tr>
<td>Net cost to date</td>
<td>$976.</td>
<td>$240 gain</td>
<td>$3,150.</td>
</tr>
<tr>
<td>Beneficiary designation</td>
<td>Wife, or children equally, or insured's estate</td>
<td>Same as Policy #1</td>
<td>Insured, if living, otherwise Policy #1</td>
</tr>
</tbody>
</table>

Mr. Able also has securities and other properties with an estimated present value of $500,000, from which he derives an annual income of $25,000. Aside from his business and his family, his principal interest is the Able Foundation, a tax exempt charitable organization.

Mr. Baker is fifty years old, and his wife is forty-eight. They have no children and no close relatives. Mr. Baker now has the following insurance:

<table>
<thead>
<tr>
<th>Policy #1</th>
<th>Policy #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue date</td>
<td>1937</td>
</tr>
<tr>
<td>Age at issue</td>
<td>25</td>
</tr>
<tr>
<td>Kind of policy</td>
<td>Ordinary life</td>
</tr>
<tr>
<td>Face amount</td>
<td>$10,000.</td>
</tr>
<tr>
<td>Cash value</td>
<td>$3,110.</td>
</tr>
<tr>
<td>Annual premium</td>
<td>$165.50</td>
</tr>
<tr>
<td>Net cost to date</td>
<td>$1,030 gain</td>
</tr>
<tr>
<td>Beneficiary designation</td>
<td>Wife, or children equally, or insured's estate</td>
</tr>
</tbody>
</table>

Mr. Charles is thirty-five years old, and his wife is twenty-eight. They have three small children. Mr. Charles' only insurance is a $10,000 G.I. ordinary life policy.
The company does not carry any insurance on its officers or employees. None of the wives has any insurance nor do they own any appreciable property (except the ABC shares owned by Mrs. Able).

The company also has a valuable employee, Jonathon Dollar, who has recently been hired away from a large company in a similar business. He is being groomed as the key production man of the company. Mr. Dollar is age forty and is married with a growing family.

MR. SUGARMAN: Before starting, let me review briefly some of the essential facts.

The ABC Company has four stockholders. Mr. Able has forty per cent of the stock and his wife twenty per cent, so that together they have sixty per cent. They are the clients of Mr. Cavitch, and while I suppose to a large measure they will determine the results here, the other gentlemen may have important interests in any decisions.

Mr. Baker holds thirty per cent of the stock. I notice that he has no children, and his situation is not quite as complicated as that of Mr. Able. Mr. Kidder is his counsel.

Mr. Wolf's client, Harry Charles, is the youngest of the group. He has ten per cent of the stock and three children.

We do not want to forget about the fourth man who is not represented here, Mr. Dollar. He is a key man the company brought in to be the future head of production. He owns no stock, but he may want an opportunity to obtain some interest in the business in the future.

Our purpose is to evaluate for the clients the insurance proposals that have been made.

I understand that there have been various insurance proposals made for Mr. Able and the company. Mr. Cavitch, since you represent the principal stockholders, tell us what has been suggested for their situation.

**Insurance to Fund a Buy-Sell Agreement**

**Desirability of Buy-Sell Agreement**

MR. CAVITCH: I think the first thing we should consider, because it was one of the principal proposals made by the insurance agent, is whether the corporation, and/or the shareholders, should have some form of death-buy-sell arrangement. This being a closely-held corporation and the proposal having come from an insurance agent, the suggestion has been made to fund such an agreement by life insurance.
I think that in exploring this subject we ought to consider briefly the fundamental question, namely, whether a buy-sell agreement is necessary or desirable.

MR. KIDDER: If it is, Mr. Wolf and I can consider our respective client’s situation in relation to each of your two clients separately. You represent two shareholders as a family group, and I may want to pursue this matter as to each of your clients on a separate basis. In other words, I may want to suggest to you that we explore Mr. Able’s situation separately from that of Mrs. Able, and I hope you will agree that we can proceed along those lines.

MR. CAVITCH: I agree. The fact that Mrs. Able is also a significant shareholder may complicate any proposal that we can mutually agree upon, for there may be different considerations involved.

My own feeling is that, generally speaking, in a closely-held corporation some form of death-buy-sell agreement is extremely desirable. And even though my clients, Mr. and Mrs. Able, together own sixty per cent of the stock and, therefore, as a pragmatic matter, control the destiny of the company, I strongly favor some agreement being reached that would convert my clients’ stock interest to cash, a note receivable, or both, upon Mr. Able’s death.

My reasoning is that generally, when a person in Mr. Able’s position, the head of the company and, for all practical purposes, the principal shareholder, dies, his continued stock interest is likely to be of little significance to his wife and children. This is because the substantial salary that Mr. Able is now receiving probably will not be available to any of the members of his family after his death, and a stock interest in a closely-held corporation can, at such time, be worth far less than it was worth during his lifetime.

I imagine that you gentlemen would favor having my clients bought out so that your clients could obtain control of the company later.

**Buy-Sell v. Stock Retirement**

MR. KIDDER: Mr. Cavitch, what are your feelings as to the type of a buy-sell agreement that should be used, that is, whether it should be a mandatory buy-sell, a mandatory stock retirement, or an optional type of buy-sell in the company? I think my client’s position on this issue will depend on your clients’ position as to the type of buy-sell agreement adopted.

MR. CAVITCH: From Mr. Able’s standpoint, an agreement granting his estate an option to “put” his shares upon his death is necessarily more favorable to him than a binding agreement, since his executors or heirs can then take a second look upon his death and decide whether they
want the shares purchased by the company. However, my clients would not stand in the way of a binding commitment at this time, if that is what you gentlemen would want on behalf of your clients. I think that there are advantages to my clients in having a high degree of certainty. Therefore, I would be opposed, in this situation, to giving the corporation the option to decide whether it will purchase Mr. Able's stock at his death.

MR. SUGARMAN: Mr. Cavitch, you have been approaching this problem from the standpoint of the corporation buying Mr. Able's stock at his death. What about having the other shareholders buy the stock?

MR. CAVITCH: All of us have to consider what appears to be the better approach. One way to accomplish this is by way of a shareholder buy-sell agreement, that is, an agreement to purchase the shares at the shareholder level. This type of an arrangement has been common in the past. It amounts to an agreement which is generally funded by insurance through the so-called cross-insurance method. Here, each shareholder signatory to the agreement obtains insurance on the other shareholder's life in an appropriate amount so that when the insured shareholder dies, the surviving shareholders will have funds with which they may personally purchase the decedent's shares.

MR. WOLF: Although my client, Mr. Charles, is interested in any buy-out arrangement that is consummated, he is a relatively low paid individual and is woefully underinsured. I doubt if he can afford the cost of insurance on the life of any of the other shareholders, even though such an arrangement might provide him with the funds to purchase additional stock in the company on the death of the insured shareholder.

MR. CAVITCH: That factor is one which would indicate a preference to a corporate redemption or retirement type of arrangement, although your client's problem in itself may not be controlling. On the other hand, since Mr. Charles' tax bracket at present is not so prohibitive, it is not out of the question for the corporation to raise his salary an appropriate amount to give him the dollars after taxes to pay any such premiums.

MR. WOLF: My client may prefer to have any such increase in pay personally, rather than have to invest the increase in insurance.

Redemption-Dividend and Gain Problems

MR. KIDDER: Mr. Cavitch, if we proceed with the theory of a corporation stock retirement program, do you feel that any such retirement upon the death of your client, Mr. Able, will create tax problems

1. This is a program where the issuing corporation purchases or redeems its shares pursuant to an agreement between the shareholders and the corporation effective upon the death of a shareholder or other specified event.
upon redemption of those shares from his estate, assuming for a moment that Mrs. Able's shares are not to be retired at the same time?²

I would like to hear your thoughts on this subject, since I am inclined to agree with Mr. Wolf that if we could work out some program to have the corporation fund such a stock retirement through life insurance, it would provide a more flexible approach for my client.

MR. CAVITCH: Let us discuss that point for a moment. The fact is that the tax difficulties, which are often present in having the corporation buy the stock of a shareholder at his death, are difficulties which may urge a buy-out at the shareholder level.

When a corporation redeems a part of its issued shares, the redemption proceeds can, in many cases, be taxed in full as though they were an ordinary dividend distribution. Where that result obtains, the redemption is a prohibitive alternative.

To make sure that a redemption will not be treated as an ordinary dividend, the relevant requirements of the Internal Revenue Code³ must be analyzed in detail before any such agreement is made.

Fortunately, in Mr. Able's situation we can approve a redemption or retirement agreement without much difficulty. The redemption at death of all of his shares will satisfy either the "complete termination" test for favorable tax treatment,⁴ or the "twenty per cent cutback" test if his wife's shares are left outstanding.⁵

MR. SUGARMAN: Are you talking about a redemption and the tax problems involved from Mr. Able's standpoint?

MR. CAVITCH: That is correct.

MR. SUGARMAN: What about Mrs. Able?

MR. CAVITCH: I think Mrs. Able's major tax problem is not one of the redemption being taxed as an ordinary dividend, but rather how to avoid a substantial capital gains tax if she survives her husband. Thus, if Mrs. Able dies first, I would urge that none of her shares be purchased or redeemed at that time. Rather, I would want her to bequeath those shares to Mr. Able so that he would maintain sixty per cent control of the company for his lifetime. Accordingly, no income tax problem would be presented if Mrs. Able predeceased her husband.

If, however, Mr. Able dies first we have difficult alternatives. If

² See INT. REV. CODE OF 1954 § 302(b) (d) [hereinafter cited as CODE §].
³ CODE §§ 302, 303, 318.
⁴ CODE § 302(b) (3).
⁵ CODE § 302(b) (2). The "twenty per cent cut-back" test will be met even though Mr. Able's estate is deemed to own Mrs. Able's shares by virtue of the attribution of ownership rules of CODE § 318. Thus, before the redemption, Mr. Abel's estate would be deemed to own sixty per cent of the outstanding shares (the estate's forty per cent plus Mrs. Able's twenty per cent); after the redemption it would be deemed to own only thirty-three and one-third per cent (Mrs. Able's 200 shares out of a total of 600 shares outstanding).
Mrs. Able's shares are redeemed, along with Mr. Able's, there will be a complete termination of Mrs. Able's interest in the corporation and, therefore, there is no danger of ordinary dividend treatment. But, unlike the case of Mr. Able's shares, upon his death there will be no step-up in the basis of Mrs. Able's shares, so that even with favorable sale or exchange treatment a substantial capital gain will be realized by Mrs. Able. If the redemption of Mrs. Able's shares could be postponed until her death, this capital gain tax could be avoided.

On the other hand, if her shares are not redeemed at the same time as Mr. Able's shares, she will be left with one-third of the outstanding shares, but with no assurance of receiving any dividends or salary. Also, Mr. Baker and Mr. Charles may not appreciate the possible interference from Mrs. Able which even a minority stock interest can engender.

Unfortunately, there is no easy answer to this problem. We may decide to plan for a redemption of Mrs. Able's shares regardless of the capital gains tax impact, or we may simply decide to obligate the parties to effect a redemption of her shares upon her later death. Alternatively, we may decide that the parties should be committed to a recapitalization of the corporation if Mrs. Able survives her husband, with Mrs. Able's 200 shares of common stock being exchanged at that time for non-voting, cumulative preferred shares having an equivalent value.

MR. SUGARMAN: As I understand it, Mr. Cavitch, your position is this: You would not want the corporation to redeem Mrs. Able's shares if she pre-deceased her husband. On Mr. Able's death, you would want the corporation to have enough insurance to buy all his shares and possibly those of Mrs. Able, depending upon what seems to be the best arrangement.

MR. CAVITCH: That is right.

Funding Corporation Buy-Sell Agreement

MR. SUGARMAN: I have one question at this point which relates to the corporation taking out enough insurance to fund the purchase of Mr. Able's 400 shares and possibly Mrs. Able's 200 shares, a total of 600 shares. I noticed that ABC Company earned $80,000 last year after taxes. We do not have the figures before us as to what the corporation's earning record has been, but assume for a moment that these shares are roughly

6. Code § 302(b) (3).
7. Mr. Able's shares will, upon his death, take a new basis equal to their fair market value at death, or one year after his death. Code § 1014(a). Accordingly, sale or exchange treatment will generally result in no gain realized.
worth ten times earnings. That would be $800 a share, and, therefore, we would be talking about a substantial amount of insurance anywhere from $300,000 to $500,000 of insurance for the Able family shares, depending upon the arrangement. Mr. Able is sixty years old and his wife is about fifty-five. This would mean a substantial amount spent for premiums.

Mr. Cavitch, put on your hat as counsel for the company. How would you justify such an expenditure?

MR. CAVITCH: I assume you do not mean justify it from the standpoint of legality, but rather how can the company afford such premiums. In other words, is it worthwhile?

MR. SUGARMAN: One thing: are such premiums deductible?

MR. CAVITCH: Such premiums clearly would not be deductible if the insurance is owned by the corporation and the corporation is the designated beneficiary. This would be the situation here because we are considering a corporate redemption type of arrangement. The premiums not being deductible emphasizes the problem of cost.

It would appear that to fund completely with insurance the buy-out of Mr. Able's stock, and perhaps Mrs. Able's stock as well, might be prohibitive simply from the standpoint of premium cost. Perhaps a sounder approach would be to acquire some insurance, perhaps $150,000 or $200,000 at most, on Mr. Able's life, to provide a cash fund that would be available for a down payment on the stock to be redeemed. This could be coupled with an agreement obligating the company to pay the balance of the purchase price in installments over a period of time such as six to ten years after death in certain stated annual sums plus interest. This type of a self-funding or self-insurance plan might be the only feasible way to approach the problem.

MR. KIDDER: I agree with this latter approach as far as my client is concerned. I feel that on the going concern basis it would be unwise to have the corporation obligated to pay at one time three, four, or five hundred thousand dollars to the Able family unless adequate funds were available through some sort of an insurance program.

I think, Mr. Cavitch, that as far as Mrs. Able is concerned, my client would prefer a program to retire her shares through some qualified installment sale type of transaction where she could spread out the capital gain that she would realize. This is, of course, assuming that she survives her husband, and the company plans to buy out both her shares and her husband's shares at the same time. The payments to her could be made over a period of years and would be paid out of corporate earnings

9. CODE § 264(a) (1).
10. See CODE § 453.
after taxes. ABC Company appears to be earning about four per cent on sales after taxes. This is not tremendous, but it is a respectable rate of earning.

Cost Reduction Through Minimum Deposit and Other Plans

MR. SUGARMAN: Mr. Cavitch, how would the company pay for this insurance? I do not know which insurance agent has been talking to Mr. Able, but I have heard all kinds of ideas about buying life insurance which costs practically nothing. There are plans, like the minimum deposit plan in which one apparently borrows out all of the cash surrender value and only pays interest. Possibly if we can use one of these methods, the company could buy more insurance. Have you looked into these?

MR. CAVITCH: In this case, the fact is that there must be a substantial amount of insurance to carry out a death stock retirement program.

Even if we purchase insurance for only part of the total redemption price, the premium cost will be substantial, and the premiums are not going to be deductible. Even the lowest cost type of permanent insurance will build up substantial cash values over the next few years, and that cash value may represent money not working in the business.

If cash is needed in the corporation’s business, one alternative might be to pledge the cash values to a bank on a loan and the proceeds of the loan used in the business. In such a case there would be, in effect, declining term insurance; that is, the amount of the loan will keep going up and the effective insurance protection will keep going down. Even though the interest that is paid to the bank on the loan will be deductible, thereby decreasing the net cost to the corporation, the company would be giving up some insurance protection.

A possible answer to the declining insurance problem might be to apply dividends from the insurance on the purchase each year of a one-year term addition to the amount of insurance protection. If the amount of annual term insurance roughly equals the amount of the loan balance, the corporation’s insurance protection will be kept relatively constant.

This procedure costs more, however, because the dividends are not being refunded. However, it is perhaps one of the least expensive methods of keeping cash in use and still providing effective insurance protection.

Corporate Purchase of Insurance Payable Directly to Shareholder

MR. SUGARMAN: There have been a number of recent cases in which the insurance carried by a corporation was payable upon death
directly to the shareholders, and the shareholders took the position that
the insurance was tax-free to them because it was insurance paid by reason
of death.\footnote{11}

What is the situation regarding premiums where a company takes
out insurance on the life of a shareholder, pays the premiums, names the
shareholder's estate or the remaining shareholders as beneficiary, and
seeks to treat these premiums, in effect, as insurance for the benefit of
the shareholders?

MR. CAVITCH: If such an arrangement constituted insurance held
for the benefit of the shareholders, the corporation might well receive a
deduction on the ground that it paid additional compensation to the in-
sureds. I, personally, have some question as to the correctness of such
a position. In any event, the price the shareholders would pay for such
an arrangement would be prohibitive; that is, the income tax thereby
generated to Mr. Able, for example, and to the other principals here in-
volved would in all probability exceed the tax saving to the corporation.

Also, I am not certain as to what the tax consequences would be on
such a hybrid plan. As I understand it, the insurance would be owned
by the corporation and it would have the right to change the beneficiary.
However, at the sufferance of the corporation, the present beneficiary
would be the insured's family. Under that arrangement, I question
whether the corporation would be properly entitled to a deduction for
the full amount of the premium paid. It is likely that the deduction
would be limited to only the value of the pure term insurance afforded
to the insured from year to year. Or, even worse, the entire amount
might be disallowed as a deduction on the ground that, since the corpo-
ration has the right to change the beneficiary, it is the real beneficiary.\footnote{12}

Furthermore, I am not satisfied, despite the case of Ducros \textit{v. Com-
mmissioner}\footnote{13} in our own Sixth Circuit, that when the insurance matures
and the proceeds become available to Mrs. Able, the proceeds represent
tax-free insurance to her. Although \textit{Ducros} so held, I am not prepared
to advise my clients to follow it because the Internal Revenue Service has
said it will not follow the \textit{Ducros} decision.\footnote{14}

I think the proper conclusion is that the insurance proceeds have been
constructively received by the corporation, which had the right to change
the beneficiary, and there was then a constructive distribution from the
corporation to the insured's widow, taxable as an ordinary dividend.

MR. KIDDER: As to the insurance carried on the life of Mr. Able

\footnotesize{\begin{itemize}
  \item[11.] See Ducros \textit{v. Commissioner}, 272 F.2d 49 (6th Cir. 1959).
  \item[12.] Code § 453.
  \item[13.] 272 F.2d 49 (6th Cir. 1959).
\end{itemize}}
by the corporation, I would want to see those insurance proceeds at maturity dedicated to the retirement of the shares of Mr. Cavitch’s client. I would not want the result to be that the insurance proceeds are paid at maturity to someone other than the corporation, unless there would be a corresponding obligation on the recipient to tender the shares of the insured to the corporation in retirement or redemption. Otherwise, I am afraid that carrying life insurance would not benefit my client at all. The purpose for the life insurance is, in the final analysis, to provide cash at death for the retirement or redemption of the decedent’s shares.

Unreasonable Accumulation of Earnings Penalty Tax

MR. SUGARMAN: That may be true, Mr. Kidder, but now that you have opened the door, what about the unreasonable accumulation of earnings penalty tax that may be lurking in the background?

Mr. Cavitch, would there be any penalty tax exposure here because of the corporation placing money into insurance premiums? Does this amount to an unreasonable accumulation of income? If it does, your clients are going to feel most of the effect of the penalty surtax. The other shareholders will not be pleased about such a result either. What are the dangers in this area?

MR. CAVITCH: This is one of those questions that cannot be satisfactorily resolved without more facts. There is no case directly on point as to whether the use of insurance to fund a corporate redemption agreement indicates an accumulation of income for the purpose of avoiding tax to the shareholders — the kind of accumulation which is subject to the penalty tax.

The fact is that in most cases the desirability, perhaps necessity, of having a death redemption agreement in a closely held corporation, plus the practical necessity of having to plan for the future, virtually dictates the use of insurance. If the corporation anticipates its future obligation without insurance by setting aside funds in a sinking fund or by investing in marketable securities, that is no better from a section 531 standpoint than having the agreement funded by insurance which happens to build up a cash value. Stated another way, the presence of insurance is no worse than other forms of funding to assure the availability of cash at a

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15. See Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957), where the issuing corporation was to receive its shares from the estate of the deceased shareholder pursuant to the shareholder stock retirement agreement. See also Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

future time when it is needed. If anything, it is probably somewhat better than actually accumulating cash, government securities, or marketable securities.

MR. WOLF: Mr. Cavitch, in representing Mr. Charles, a ten percent shareholder, I agree that there may be no absolute conclusion that we can reach as to the application of section 531. However, it is extremely important to the remaining shareholders as to whether there is a section 531 tax imposed on this corporation on any redemption of the shares of your clients. It is certainly going to hurt Mr. Baker and Mr. Charles as remaining shareholders, though not your clients, after their shares are redeemed, if the corporation has to pay a section 531 tax. We may have to arrive at some preliminary conclusions as to the section 531 issue.

MR. CAVITCH: You are quite right. If the thrust of this tax is first asserted after the redemption of the Ables' shares, it is likely to affect your clients rather than mine. However, if the pay-out to the Able family is in installments, any tax deficiency affecting the company's finances can be a serious matter to my clients also.

MR. SUGARMAN: Just where does the case of Pelton Steel Casting Co. v. Commissioner fit into this picture?

MR. CAVITCH: The Pelton case did not involve insurance at all, nor did it involve an agreement for the future redemption of shares. It involved the redemption of a majority shareholder's shares, not pursuant to a prior arrangement. The Court of Appeals for the Seventh Circuit held that the use of corporate funds to redeem those shares, rather than to pay dividends, was prompted by the motivation to avoid income tax to the shareholders. In view of the particular circumstances in that case, I do not think that it is likely to be a widely-followed precedent. In any event, the case bears on the question of whether a redemption might give rise to the imposition of a penalty tax, and not on the question of how insurance funding aggravates the situation.

MR. SUGARMAN: Perhaps I might suggest another approach to this case. I note that Mr. Able has a substantial amount of cash, as well as other liquid investments. Does Mr. Able need a buy-sell agreement in this situation at all? Further, does the corporation need insurance at all? As I see it, Mr. Able appears to have sufficient liquid securities to pay any federal estate tax. Also, his executor could elect to use section 6166 of the Internal Revenue Code which allows ten years to pay the estate tax where the estate has a substantial amount of stock in a closely-held corporation. Mr. Able probably has the requisite thirty-five percent of his gross estate or fifty percent of his net estate in stock of the

17. 251 F.2d 278 (7th Cir. 1958).
ABC Company. From the remaining shareholders’ point of view, why not allow Mrs. Able acquire all of Mr. Able’s stock, and allow the executor to pay the federal estate tax out of Mr. Able’s cash or, if necessary, elect to use section 6166?

MR. CAVITCH: Although I do not believe that there is need for a redemption agreement or a buy-sell agreement for liquidity purposes in Mr. Able’s estate, I am a little disturbed about allowing control of the corporation to devolve upon Mrs. Able on the death of her husband.

MR. KIDDER: I certainly am disturbed as well.

MR. SUGARMAN: All right, gentlemen, I think we have found our business reason for a shareholder buy-sell agreement or stock retirement agreement.

MR. CAVITCH: Frankly, I think that there is a business reason despite the adverse implications of the Pelton case. You should bear in mind that Pelton did not involve any agreement for the mandatory retirement of shares in the future. I think that the presence of such an agreement immeasurably strengthens our case under section 531 and makes the risk of a penalty tax relatively minimal.

MR. WOLF: It is important from Mr. Baker’s and Mr. Charles’ standpoint that the shares of Mr. and Mrs. Able be acquired by the corporation upon the death of Mr. Able. If Mr. Able predeceases Mrs. Able it would be undesirable that she remain a shareholder in this corporation, whether as a forty per cent or a sixty per cent shareholder. Her interests in this corporation after the death of Mr. Able will be completely different than they now are. Mr. Able is presently drawing a salary for working in the business, and he is not too concerned about any dividend payments. Once he is gone and Mrs. Able becomes a silent controlling or even minority shareholder, her objectives may be the payment of larger dividends and the holding down of salaries. These are thoughts which would probably be at odds with the purposes and objectives of the other shareholders, Mr. Baker and Mr. Charles.

MR. SUGARMAN: I assume that there are a number of other points of view which we could discuss including that of Mr. Dollar, who also has an interest in eliminating absentee shareholders such as Mrs. Able on the death of Mr. Able. However, we must move on.

Mr. Kidder, I understand that your client, Mr. Baker, has had an insurance proposal which you would like to discuss.

DEFERRED COMPENSATION PLANS — KEY MAN INSURANCE

MR. KIDDER: I have discussed with my client, Mr. Baker, the advisability of having the corporation purchase key man insurance for
him,\textsuperscript{18} and at the time I asked him whether he had any type of a deferred compensation agreement with the corporation.

Mr. Baker is a thirty per cent shareholder in the corporation. He is fifty years old, ten years junior to Mr. Able. I discussed with him the problem of funds for his family after death and also the desirability of having some type of a compensation agreement.

To begin with, it would be well to relate what I told him with respect to the various types of employment contracts that can be utilized and some of the problems that may arise, as well as the recommendations that I tentatively made to him.

\textit{Deferred Compensation Plans}

Deferred compensation agreements can be cast in the form of a regular employment contract coupled with the absolute obligation of the company to pay the employee a fixed amount in retirement or, in the alternative, coupled with an obligation to pay the employee only if he agrees to be available for consultation.\textsuperscript{19}

There is another type of agreement that we discussed only briefly, because there appeared to be too many complex problems to be worthwhile. This type of employment agreement is where the employer is required to set aside funds with a trustee or to escrow funds to insure that the employee will be paid in retirement under his employment contract.

Such an approach, I concluded, was dangerous, first of all, to my client,\textsuperscript{20} and, secondly, from the corporation's standpoint.\textsuperscript{21} I advised Mr. Baker that if the employer sets aside funds with a trustee or to escrow funds to insure that the employee's retirement payments, and the employee's interests in that fund are forfeitable, such as where the employee has to consult and agree not to compete in order to continue to receive payments, the employee will have no income tax problem until such time as he receives the

\begin{itemize}
\item \textsuperscript{18} The employer-corporation is the owner of life insurance carried on the life of a key employee-insured where the corporation is designated the beneficiary at death. See discussion at 321, infra.
\item \textsuperscript{19} See examples in Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.
\item \textsuperscript{20} CODE § 402(b); Samuel J. Coppola, 35 T.C. 405 (1960); E.T. Sproull, 16 T.C. 244 (1951), aff'd, 194 F.2d 541 (6th Cir. 1952). Cf. Rev. Rul. 62-74, INT. REV. BULL. 1962-22, 7; but cf. Drysdale v. Commissioner, 277 F.2d 413 (6th Cir. 1960). There also can be severe tax consequences where the employer purchases a retirement annuity for the employee. Chrysler Corp., 33 T.C. 843 (1960), aff'd, 289 F.2d 643 (6th Cir. 1961), cert. denied, 368 U.S. 876 (1961); United States v. Drescher, 179 F.2d 863 (2nd Cir. 1950); Hackett v. Commissioner, 159 F.2d 121 (1st Cir. 1946); Renton K. Brodie, 1 T.C. 275 (1942); Richard R. Dupree, 1 T.C. 113 (1942).
\end{itemize}
payments in retirement. I pointed out that there would be substantial objection to this plan from the corporation's standpoint if I were to come to this meeting and suggest such an arrangement.

MR. CAVITCH: I am glad that you are not going to make such a suggestion as I would have an overwhelming objection to it. I could not advise the corporation to set apart a significant amount of funds in a trust which would be outside its control and not available for use in the business.

If the right of an employee to receive these monies was contingent on future services, the employer would probably receive no deduction at all for the retirement payments. The company would not be entitled to any deduction at the time that it paid the money into a trust or other irrevocable escrow, and further, it would probably not receive any deduction when the monies were actually paid out to the employee in retirement. The result is that the employer risks losing the deduction entirely and does not have the use of the funds for its business.

MR. KIDDER: I consider Mr. Baker's position with the corporation to be that of a key man, and I would prefer that the company give consideration to a deferred compensation arrangement program. The Internal Revenue Service has now ruled in this area, and I think one of these programs can be set up safely.

From the employee's standpoint, it is usually desirable to have an employment contract under which the employer agrees to make payments in future years with no contingency. The employer-corporation merely agrees to make these payments in retirement to the employee at a given amount per month or per year, and the employee has no further employment obligations to the corporation. However, in such a case, if the employee dies and the retirement payments are continued to his wife, heirs, or estate, there would be some question as to whether that recipient could take advantage of the $5,000 death benefit exclusion. If the employment contract has some forfeitable feature, then the employee's designee would receive the $5,000 exclusion. Mr. Baker feels, at least at this time, that it would be far better from his standpoint to have an absolute obligation of the corporation to make retirement payments.

25. The necessary feature of forfeitability as required by CODE § 101(b)(2)(B) would be lacking.
Key Man Insurance

Next I discussed with Mr. Baker the problems that arise when an employee dies during employment or in retirement. This discussion related to the use of key man insurance.

Key man insurance is that type of insurance where the corporation takes out a policy on the life of a key executive. The corporation owns the policy and is designated the beneficiary. This is the same type of insurance that we mentioned earlier when we discussed the various ways that funds are obtained with which to retire or redeem stock of a deceased shareholder-employee. 26

I feel that key man insurance is a helpful tool as it can be used in conjunction with deferred compensation agreements. Should my client die while actively employed, the proceeds of such a policy will provide immediate funds to the corporation. We have previously discussed the unreasonable accumulations problem, but I feel that in the area of deferred compensation the use of key man insurance does not aggravate that problem. 27

If the ABC Company should purchase a policy of ordinary life insurance and build a cash reserve through the cash surrender value, there would be a ready source for borrowing funds if at a future date the corporation needs money. The corporation will not have to cash surrender the policy as it can borrow against the policy.

Another good feature of working out a program of key man insurance in conjunction with a deferred compensation agreement is that when the employee reaches retirement, the corporation can, if it so desires, convert or exchange the key man insurance policy to a retirement annuity policy. The corporation may prefer, however, to exchange the policy for a fully paid-up life insurance policy. Either type of exchange can be accomplished tax-free. 28

MR. CAVITCH: I assume, Mr. Kidder, that you are speaking of the kind of pension contract which would be funded by corporate-owned insurance. That is, the corporation would simply promise to pay either Mr. Baker or Mr. Baker's widow a certain predetermined amount, and to have the funds available at that time, it would take out an appropriate life insurance or retirement annuity policy. Is that right?

MR. KIDDER: Most assuredly. It would be dangerous, tax-wise, for the corporation to turn over any retirement annuity contract to Mr. Baker. 29 As a matter of fact, it would be better to have the insurance

26. See discussion at 312, supra.
27. Emeloid Co. v. Commissioner, 189 F.2d 230 (3rd Cir. 1951).
28. CODE § 1035.
company make any retirement payments directly to the corporation. The employee would then rely solely on the general obligation of the corporation to pay him.\textsuperscript{30} Otherwise, income tax consequences may result at or before retirement based upon the value of any such retirement annuity contract, and the employee, in such a case, would have a tax to pay. He would have to rely on other funds to pay the federal income tax which would be due before he had received the cash payments.

To summarize some of the advantages to the company, should it decide to purchase a key man insurance policy on the life of Mr. Baker, it can be said that:

1. A key man insurance policy will provide substantial cash at maturity. The proceeds that the corporation receives will be tax-free.
2. The cost of such a program over the life expectancy of the employee, on an annual basis, is not prohibitive.
3. The cash surrender value in the policy offers flexibility. Funds are taken from the cash account, if there is excess cash, and, in effect, are invested in the cash surrender value of the life insurance policy. By so doing, this retains in the company a ready source of funds to that extent.

As to the disadvantages of this type of program it can be said that:

1. The expense involved in carrying out this program, the so-called after-tax dollar, which results in a cash drain to that extent.
2. The premiums might be a little high in the early years.
3. The insurance may be a bad gamble in that the employee may live a long time. If the employee lives well into retirement, the company will have spent a substantial amount of money and the policy will not have matured.

\hspace{1cm} \textit{Tying Key Man Insurance to Deferred Compensation Plan}

\textbf{MR. SUGARMAN:} Mr. Kidder, I am not quite sure whether the life insurance is to be tied to the deferred compensation agreement. You indicated that the insurance should not fund deferred compensation by being a part of the same contract. Is that correct?

\textbf{MR. KIDDER:} It would be unwise to provide in any employment contract that the corporation would agree to buy a specified amount of insurance on the life of the employee to provide funds with which to make payments in retirement or upon the death of the employee.\textsuperscript{31}

\textbf{MR. SUGARMAN:} What would be the federal estate tax effect of this to Mr. Baker?

\textbf{MR. KIDDER:} This is a difficult area of federal estate taxes. We

\hspace{1cm} 30. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

\hspace{1cm} 31. Cf. Reg. § 1.61-2(d) (2) (1957).
have considered what I feel is a traditional type of employment contract. Such a contract, in effect, provides that when the employee reaches retirement age, the corporation will pay to him a specified amount per month, and should he die prior to retirement or should he die while in retirement not having received all of the payments, the corporation will continue to make the payments to his widow or to his heirs. This type of an employment contract is taxable in the estate of the employee. However, the key man insurance which the corporation would own would not be an element of taxability in the estate of the employee.

MR. SUGARMAN: Do you mean if the insurance proceeds are paid by the company to the widow?

MR. KIDDER: No, I mean that the key man life insurance itself would not be includible in the estate of the employee, but that the employment contract would be includible at its present fair market value.

MR. SUGARMAN: What is the effect of the case of Bahen v. United States? I understand that the court indicated a distinction which should be watched when drafting employment agreements.

MR. KIDDER: The Bahen case involved two separate types of employment plans of an employer. It pointed to the possibility of having a death benefit agreement that might not be taxable in the estate of the employee. The estate tax impact under section 2039 of the Internal Revenue Code seems to apply in the area where the decedent-employee has a right to payments during his lifetime and would have received those payments but for his death, as in our example of the deferred compensation agreement.

In the Bahen case there were two plans which the court integrated as one plan and determined the taxability on that integrated basis. However, the court definitely indicated that in the absence of the integration of those two plans as a single plan, one of the plans would not have been includible as a part of the employee’s taxable estate. That plan was the bare agreement of the corporation to make death payments to the widow or heirs of the deceased employee; under that agreement the employee had no right to receive any sums during his lifetime. The court in Bahen said that if that type of plan were present, and that type alone, such a plan would not be includible in the estate of the employee upon his death for federal estate tax purposes. In effect, there would be no taxable property. The Court of Claims in the Bahen case considered the question of taxability under many of the troublesome areas of the federal estate tax law, and this portion of the court’s opinion was more than dictum as a decision was made on this point, which required the determination that the two plans should be integrated.

MR. SUGARMAN: Mr. Kidder, you indicated that you had some ideas which you wanted to explore concerning split-dollar insurance. Would you discuss those now?

**Description**

MR. KIDDER: A split-dollar insurance program can be a fine device, and I definitely feel that there is a place for it in this program.

I would like to review, briefly, the nature of a split-dollar insurance plan. The plan involves the use of life insurance on the life of the employee. The employer and employee each pay a portion of the life insurance premium.

The annual amount that the employer generally pays is an amount equal to the cash surrender value increase that the life insurance policy has each year. The employee pays the balance. If there is a participating type of life insurance policy, the dollar obligation of the employee would be commensurately reduced each year. When such a policy matures by reason of the employee’s death, the employer receives the amount of money that he has paid into the policy, which is the cash surrender value just prior to death. The widow or the heirs of the employee would receive the balance of the proceeds as beneficiaries under the life insurance policy. Such proceeds are received tax-free.\(^3\)

MR. SUGARMAN: Let me emphasize a point that you mentioned. This is insurance for the benefit of the employee. This is not company insurance.

MR. KIDDER: Yes, this is life insurance that benefits the employee. The company has to “loan” some of its funds to accomplish this result, but split-dollar insurance is basically for the benefit of the employee and his family.

MR. SUGARMAN: I assume that you feel as long as the company may be considering buying insurance for Mr. Able to help his situation through the redemption of his stock, you might as well see if the company can do something to assist your client in his own estate planning through a split-dollar insurance plan.

MR. KIDDER: Yes, I would. I think that we should discuss the two types of split-dollar insurance that are generally considered.

First, there is the type of split-dollar policy where the corporation itself is the applicant and owner of the policy in conjunction with the employee and each party to the policy designates a beneficiary. The corporation names itself as a beneficiary to the extent of the cash surrender value. The employee designates his widow or his heirs as beneficiary.

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of the other portion of the policy. Thus, the longer the policy is held, the larger the cash surrender value becomes and the more the employee's so-called benefits under the program decrease.

There is a second approach to split-dollar insurance which is to have the employee apply for and obtain an ordinary life insurance policy. He then enters into an agreement with his employer to the effect that prior to the annual premium payment date, the employer will advance to the employee an amount equal to the annual increase in the cash surrender value. The employee then collaterally assigns the policy to the employer to secure this loan.

There is an advantage to this second type of approach to the problem, as far as the employee is concerned. If the plan proceeds this way, the employer might consider making a larger loan than the cash surrender value security of the policy, since in the initial years of carrying such a policy, the premiums can be expensive as far as the employee is concerned.

Revenue Ruling 55-713

When the Internal Revenue Service ruled on split-dollar insurance in 1955, the underlying facts upon which the ruling issued involved a case in which the employer was the owner-applicant. The employer was named the policy beneficiary for an amount equal to the cash surrender value, and the employee, as co-owner, was named the policy beneficiary for the balance. An interesting point about that ruling was that the corporation had purchased the policy and had actually carried it for the first year of its existence. The corporation then entered into a separate split-dollar agreement with the employee under which he became a co-owner of the policy after the first year. This latter step would help alleviate the high cost incidence to the employee in the first year or so.

MR. SUGARMAN: You have referred to an Internal Revenue Service ruling. Do you think it would apply to our particular case with the ABC Company, and what are the risks involved?

MR. KIDDER: The ruling was intended to apply to an employee as such. The Internal Revenue Service apparently did not intend to pass on a case where a substantial shareholder was involved with the split-dollar insurance program. The Internal Revenue Service apparently feels that some additional factors must be considered where a shareholder-employee is the co-owner of the policy with the corporation and that these factors were not considered in the published ruling. Moreover, the Internal Revenue Service refuses to issue advance rulings in the shareholder cases. I have tried to weigh the exposure in such case. I suggest that

in the shareholder situation, the Commissioner might argue that to the extent the corporation made available funds to its shareholders in a split-dollar program, such would constitute a dividend to the shareholder. However, in the *J. Simpson Dean* case, the Tax Court said that, if there is an attribution of income to the employee by reason of his having the use of funds free of any interest charge, the employee would nevertheless be entitled to an interest deduction in the same amount. The Tax Court, by way of dictum, indicated that there was no reason to attack the tax-free loan of funds in the employee situation. This should also apply in the shareholder situation. To the extent there is exposure, as I see it, it is really that of the corporation.

MR. CAVITCH: I have wondered about that. It might be argued that the corporation constructively received interest from the insured, which would be taxable income to it, with the risk that it would have no offsetting constructive deduction because, perhaps, the benefit which it conferred upon its shareholder-employee was a dividend. The result is that the company may be whipsawed by virtue of having provided a benefit which represents an out-of-pocket expense to the corporation, while it gets nothing in return for its loan. It ties up funds without interest, and the result is that the employer may be taxed on some theory that it has received constructive income.

MR. KIDDER: The double or triple attribute construction you have discussed is very peculiar. As I see it, however, that seems to be the only exposure since the basic premise is that the employer, at all times, is going to have the cash surrender value of the split-dollar policy secured to it in one way or another. The policy is either going to be collaterally assigned, similar to the way in which a bank loan is handled, or the employer is going to be a co-owner of the policy.

*Employer and Other Considerations*

MR. SUGARMAN: Before deciding which approach should be followed in adopting a split-dollar program, it would be wise to consider the relevant Ohio corporation law. The first approach, where both parties are owners of the policy, might create a different result under Ohio law than the second approach, which is strictly a loan.

MR. KIDDER: It would seem that, under Ohio law prohibiting a corporation from making loans to its officers, shareholders, or directors, the better procedure would be to have the corporation own the policy in conjunction with the employee.

MR. SUGARMAN: Someone suggested to me that it might be a good idea to have Mrs. Baker own the policy so that upon Mr. Baker's

death, the proceeds would be paid to her, yet the policy would not be includible in Mr. Baker's estate.

MR. CAVITCH: Do you mean that Mrs. Baker should own the term insurance portion of the split-dollar policy?

MR. SUGARMAN: Yes, the company could still advance money for the portion of the premium equal to the annual cash surrender value increase, and Mrs. Baker could pay the premium relating to the term portion of the policy. Mrs. Baker would be the owner of the policy and would have all the rights that the company did not have. Mr. Baker would not be involved at all.

MR. CAVITCH: Your suggestion raises and emphasizes the uncertainty as to all of the factors upon which the ruling was based. If the benefit of that ruling was intended by the Internal Revenue Service to be some form of non-taxable employee fringe benefit, as has been suggested by some, then, by Mrs. Baker not being an employee, there is the basic question of whether the Internal Revenue Service would approve of such an arrangement.

MR. SUGARMAN: This discussion has suggested a problem as to possible corporate exposure if Mrs. Baker owns the policy. But, let me mention another approach at this point. Why not have the corporation take out an ordinary life insurance policy on the life of Mr. Baker, payable to the corporation, and then permit Mrs. Baker or Mr. Baker, whatever Mr. Kidder recommends to his client, to take out a term rider on the policy?

MR. KIDDER: Split-dollar insurance programs have been moving in this direction. The reason for this is that there are some areas where it becomes difficult to convince all interests involved that it is sound business to have the corporation continually tie up its funds in the cash surrender value of a split-dollar policy. Although the corporation probably could pledge the split-dollar policy for a loan if need be, the psychology of this creates a problem.

A new type of insurance policy is developing which seems to have merit. The plan is to have the corporation purchase an ordinary life policy, name itself beneficiary, and collect the entire proceeds on the policy at the time it matures. Many insurance companies now provide a term insurance rider that is added to the ordinary life policy. It carries a separate low premium. The theory is to have the employee own the term rider, designate his own beneficiary, and through payroll deductions, or otherwise, pay for the cost of the term rider. In this way, the corporation actually carries key man insurance, while the employee, on the other hand, owns his own term type of policy.

MR. SUGARMAN: It looks as though split-dollar and key man in-
surance objectives can be accomplished through the corporation purchasing this type of a life insurance policy on the employee's life.

MR. KIDDER: This method may avoid over-planning with multiple types of policies, and it would appear that a substantial saving might be made with such a policy.

**OTHER INSURANCE PLANS: GROUP TERM INSURANCE**

MR. SUGARMAN: Mr. Wolf, on behalf of Mr. Charles, the junior executive of this company, would you express your views on these insurance programs?

MR. WOLF: Mr. Charles is not drawing a large salary, thus, he is not particularly interested in a deferred compensation arrangement for himself at the present time. He would rather have the dollars now. In other words, he is not in a high tax bracket, so there is no great tax incentive for him to try to push any of his present income into the future. However, he is in need of more insurance.

One rather inexpensive insurance program which this company might consider is the purchase of group term life insurance. Such insurance would benefit not only Mr. Charles, but Mr. Able, Mr. Baker, and the other employees of the company as well.

There are limits under the Ohio law on the amount of group term insurance that may be written on the life of an employee.° However, those limits do permit substantial group insurance coverage. Thus, Ohio law permits $20,000 coverage, and if 150 per cent of the employee's compensation exceeds $20,000, then the limit is an amount equal to 150 per cent of his compensation, but in no event may it exceed $40,000.

Group term insurance, of course, is considerably less expensive than the normal types of life insurance. In addition, there are distinct tax advantages in group term insurance, advantages which run both to the employer and the employee. The premiums on such insurance are deductible by the employer,° and no portion of them is includible in the taxable income of the employee.° The death proceeds, of course, receive the same income tax-free treatment as do other normal types of life insurance.

Actually, as far as federal taxes are concerned, the only dangling end is that the insurance, when payable on death, presumably will be

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37. **Ohio Rev. Code** § 3917.01(C).
38. **L. O. 1014, 2 Cum. Bull. 88.**
includible for estate tax purposes in the estate of the insured employee. There may even be a solution to this problem. There have been persons who have thought of ways to "gimmick up" group term insurance to obtain the advantages of deductibility of premiums to the corporation and non-taxability of premiums to the individual. Further, they have tied it in with a buy-sell agreement; that is, they have used it as cross-insurance to fund a buy-sell agreement between shareholders.

We should go cautiously if we institute a program of group insurance, and we should not attempt to extend it beyond what it really is — a fringe benefit for the employees.

The Internal Revenue Service recently considered certain tax aspects of a plan involving group term life insurance. The group policy under the plan would have provided $2,000 of insurance coverage to those employees whose compensation was less than $6,000 and $100,000 of coverage to those employees whose compensation exceeded $6,000. Only the stockholders of the company were in the latter class, and there were only two of them. In the request to the Internal Revenue Service for a ruling, three questions were posed: (1) Would the premiums be deductible by the company? (2) What would be the estate tax consequences of the transaction? And (3) would the arrangement in any way be considered as a transfer of the policies between the shareholders for a valuable consideration? In connection with the last question it should be noted that the group insurance plan was to have been dove-tailed with a buy-sell agreement between the shareholders, the insurance proceeds being earmarked to buy out the stock of the shareholder who was the first to die.

The Internal Revenue Service ruled that the premiums on this type of policy, even though it was group term insurance, would not be deductible. It stated that the plan would not provide a feeling of contentment for those employees who did not own stock in the company, further, that the objective sought to be accomplished was one that was personal to the shareholders, and, thus, that the plan was not directly related to the employer's trade or business.

The Internal Revenue Service refused to rule on the estate tax aspects of the problem or whether a transfer for valuable consideration was involved.

MR. SUGARMAN: Did the Internal Revenue Service rule as to whether an employee, for whom there was a $100,000 insurance policy, would be taxed on the premiums paid by the company?

41. Code § 2042(2).
42. See discussion at 330-31, infra.
MR. WOLF: No, they did not rule on that question.

The fact that the premiums would not be deductible would probably be sufficient to kill that type of plan anyway. However, my own view is that the premiums would be held taxable to the employees. The fact that the premiums in the ordinary group term situation are not taxable to the employees is, or was, a gratuitous exception to the general rule and seems to have been based on a fringe benefit theory. The insurance in the case under consideration went far beyond the normal concepts of a fringe benefit.

MR. SUGARMAN: Let us return to the estate tax question you mentioned before. Could you eliminate Mr. Charles' portion of the group insurance from his estate for federal estate tax purposes?

MR. WOLF: The proceeds of insurance are includible in the estate of an insured if the insured at the time of his death has an incident of ownership in the policy.44

In the normal policy there are a number of features or incidents of ownership, such as the right to the cash surrender value, the right to borrow against the cash surrender value, the irrevocable right to designate a beneficiary, and the like. If the insured irrevocably divests himself of all these incidents of ownership, then the proceeds of the policy normally will not be includible in his estate for estate tax purposes.

In a group term life insurance policy there are few incidents of ownership in the employee in the first place. The most obvious is the right of the employee to designate the beneficiary. The question is: Can the employee irrevocably divest himself of that right? Most insurance companies will accept such an irrevocable designation of a beneficiary for filing, although there are some that will not. I know of no Ohio law that would prevent such action, so my view is that it may be done if one is dealing with the right insurance company.

MR. SUGARMAN: If we find that it can be worked out with the insurance company so that the spouse is the irrevocably designated beneficiary of the policy and the husband-employee has no incidents of ownership, is it not possible that, in effect, every day he works he is making a transfer which is completed only on death and includible in the gross estate for that reason?

MR. WOLF: I know of no ruling to this effect. However, a different pitfall is the provision of Ohio law which requires that all policies of group insurance must provide a conversion right. It is the employee who has that right under Ohio law as a part of his group insurance policy. When the employee terminates his employment he has the right to convert his group insurance to ordinary life insurance at his attained age.

without physical examination. Nevertheless, Ohio law does not specifically deny the right of assignment, and presumably, that right can be assigned. If so, such an assignment might be the way to avoid this pitfall.

**Family Tax Planning Related to Insurance**

*Ownership of Insurance*

**MR. SUGARMAN:** We have considered various insurance programs from the standpoint of the ABC Company as well as its stockholders and executives. We should now consider these programs in terms of the respective employee-family situations.

Mr. Kidder, you were the one who raised the question of insurance for the benefit of your client, Mr. Baker, or his estate. Would you start the discussion as to what you have in mind regarding ownership of insurance policies and related problems?

**MR. KIDDER:** Turning to the problems of family ownership of life insurance, we should consider the problems of insurance policies which the husband owns as the insured and in which he has named his wife as beneficiary. In my discussion, I will assume that the wife is the surviving spouse. We should explore the manner of dealing with life insurance policies owned by the husband and also consider the advisability of the wife purchasing insurance on the life of her husband.

Let us first explore the transfer of insurance policies from the husband to his wife. The purpose in transferring these policies, if accomplished correctly, is to keep the life insurance out of the husband's estate and the gift taxes to a minimum.

There are three generally accepted ways to transfer existing life insurance policies. There can be an irrevocable assignment of the policy from husband to wife. There can be what is known as an endorsement of ownership of the policy from husband to wife. And there is a third but somewhat dangerous way of designating an irrevocable beneficiary. The reason for the danger in the third method is that in many situations where this is done, the husband probably has retained other rights of ownership which results in the life insurance remaining a part of the husband's estate.

If there is an outright transfer from the husband to his wife of an existing insurance policy, the transfer will constitute a gift if the husband does not retain any reversionary interest in the policy. If the husband

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45. *Ohio Rev. Code* § 3917.06(E).
by his right to the marital deduction,47 the $3,000 exclusion,48 and his unused lifetime exemption.49

Should the insured-husband transfer insurance policies to his wife and die within three years of the transfer, the problem of a transfer in contemplation of death is raised, and the gift plan may be ineffectual for that reason.50

There are also future tax problems, once the ownership of a policy is in the hands of the wife. This is an area that many times is passed over without much consideration. Where the wife owns the policy and has named someone other than herself as beneficiary, as where she names her children as beneficiaries, and the policy matures, the proceeds are paid directly to the children. However, the wife has made a gift because she owned the policy until the husband's death and continued to have the right to control the beneficial designation.51 However, for income tax purposes, the proceeds are received by the beneficiary-children tax-free as proceeds of an insurance policy payable on death.

Take the case of the wife who owns life insurance policies on her husband's life, either by reason of having had the policies assigned to her or having purchased them, and who predeceases her husband. Upon her death prior to the death of her husband, she will own valuable property, the insurance policy, which will be includable in her estate,52 not at the maturity face value, but at the then fair market value of the policy. Generally, that value is approximately the cash surrender value.53

If the policy is one that is fully paid up, the tax considerations are somewhat different in terms of the federal gift taxes that are applicable. Where there is a transfer of a fully paid-up policy from the husband to the wife, the value of the gift is the cost of replacement of a fully paid-up policy of the same type at that moment of time.54 Normally, in such a situation, the insured husband is much older than he was when the policy was first obtained.

MR. SUGARMAN: Mr. Baker does not appear to have much insurance now. I would assume that your recommendation, Mr. Kidder, might well be that any new insurance on Mr. Baker's life should be taken

47. CODE § 2523.
49. CODE § 2521.
52. CODE § 2033.
53. The value will actually be the interpolated terminal reserve. Reg. § 25.2512-6 (1958).
out by Mrs. Baker. But what about Mr. Able, Mr. Cavitch? Does he have a substantial amount of insurance?

MR. CAVITCH: Mr. Able probably is not going to be too interested in buying additional insurance for himself, because of the high cost at his age, because of his other present holdings, and because he does not otherwise seem to need it.

But the question arises as to whether he should transfer some of his policies by way of a gift to Mrs. Able, the thought being that such a gift will reduce his taxable estate for federal estate tax purposes. This can be a significant step to take in estate planning.

MR. SUGARMAN: Consider this approach. Why not have Mr. Able transfer or sell one of his existing policies, say the $100,000 policy, to the corporation?

MR. CAVITCH: His willingness to do that might depend upon whether he would be willing simply to cash in the policy. The same considerations ought to prevail. He may be quite unwilling to sell that policy because it may be a good one to have in view of his life expectancy and the premium cost.

MR. SUGARMAN: Yes, but if we are to follow one of our prior suggestions of having the corporation take out additional insurance on his life, would not there be a benefit to the corporation in buying the policy — in other words, acquire the existing policy instead of taking out a new policy?

MR. CAVITCH: Yes, I would think so, but it may not be beneficial to Mr. Able.

MR. SUGARMAN: What would be the various tax consequences if that procedure were followed?

MR. CAVITCH: Mr. Able’s $100,000 policy has a present cash value of $11,600. The net cost of the policy to date is $6,125. If Mr. Able sells the policy to the corporation, the income tax consequences would be the same as though he had surrendered the policy to the insurance company for its cash surrender value. Mr. Able would have a profit which would probably be taxable to him as ordinary income, and he also would be giving up a substantial portion of the benefit of the policy by reason of his beneficiary having lost the right to receive the proceeds at death. However, he would be relieved of paying the premiums and would have the protection as a stockholder of the insurance as an asset of the corporation.

MR. SUGARMAN: From the standpoint of the corporation, what would be the tax consequences to it of owning the policy transferred by Mr. Able?

MR. CAVITCH: The tax consequences would be the same as if the corporation had applied for and taken out the policy initially. Even
though the corporation will have purchased for value an existing insurance policy, the burdensome income tax treatment generally applicable with respect to transferees for value will not apply. That unfavorable tax treatment does not apply when a corporation purchases an existing policy on the life of a shareholder or officer of that corporation. The death proceeds ultimately received by the corporation will constitute tax-free insurance proceeds to it.

From the standpoint of the corporation, there would be a benefit to it by obtaining the existing policy, assuming that the corporation otherwise planned to purchase a $100,000 policy on the life of Mr. Able. There would be lower premiums to the corporation than would obtain on a new policy at Mr. Able's present age.

MR. SUGARMAN: Mr. Able would receive $11,600 in cash, and he would have a small amount of income tax to pay on the gain over his cost of $6,125. The basic question would seem to be whether you, Mr. Kidder and Mr. Wolf, can, for your respective clients, reach an understanding as to a buy-sell agreement.

MR. CAVITCH: I think that is correct. If Mr. Able is to sell his present $100,000 life insurance policy to the company without economic loss to him, the price to be paid at his death for his shares of stock would have to be adjusted in some way to compensate his family for the loss of the proceeds of insurance at that time.

MR. KIDDER: Mr. Sugarman, I suggest that all of the shareholders would want an analysis as to whether the savings to the corporation in premium cost by taking over Mr. Able's existing policy and paying out $11,600 at this time, in order to pick up the $100,000 policy at a lower annual premium cost, is worthwhile to the corporation. Although the corporation can immediately borrow against the policy and, in effect, net the cost to carry the policy, I would have some question, from Mr. Baker's standpoint, as to increasing the price to be paid for the shares owned by Mr. Able at his death by reason of having purchased from him the $100,000 policy. Mr. Able is presently insurable. Mr. Baker also is insurable, and before any decision is reached there should be an analysis to determine whether an adjustment should be made in the price paid for shares under any buy-sell agreement, or whether the corporation should simply purchase an ordinary life insurance policy on Mr. Able's life and then proceed with a stock retirement program.

MR. SUGARMAN: I suggest that we go on to another point. Mr. Kidder, will you continue with your discussion as to the forms of owner-

55. CODE § 101(a) (2).
56. CODE § 101(a) (2) (B)
57. CODE § 101(a) (1).
ship of insurance and your recommendations regarding the various parties involved?

Life Insurance Trusts

MR. KIDDER: If there is a considerable amount of life insurance involved, a plan whereby the insurance is integrated with the assets of the probate estate through a life insurance trust may be desirable. Although Mr. Baker now has a thirty per cent interest in the company, the prospects are good that he may succeed to a larger percentage interest if the principals are able to work out a stock retirement program. Also, this company may become extremely prosperous on its own, in which event a thirty per cent interest will be worth substantially more than it is today.

The use of a life insurance trust in estate planning is generally considered to be a procedure whereby the owner of life insurance policies transfers them to a trustee under the terms and provisions of a trust agreement. The trust then sets forth the disposition of the insurance proceeds upon the death of the insured. When the insured dies, the proceeds of the life insurance are collected by the trustee, and the trust instrument sets forth the manner of distribution much the same as is provided in a will. The trust agreement is generally flexible and usually provides a method to coordinate, through the trust, the non-probate assets with the probate assets through a pour-over provision in the will to the life insurance trust upon death.58

As a general rule, the life insurance trust is revocable and normally is unfunded.59 A revocable trust offers a great deal of flexibility and can be changed if the tax laws change or if a change is desired for non-tax reasons. This type of a revocable life insurance trust does not eliminate the life insurance policies from the insured’s estate.60

If a revocable funded insurance trust is used, the income derived by the trustee to be used for the payment of premiums, being income from a revocable trust, would be taxable to the settlor of the trust.61

A different problem is presented where the wife, as owner of life insurance on her husband, sets up a revocable insurance trust for her own

58. See the recent legislation in Ohio permitting the flexible use of life insurance trusts which are supplemented by “pour-over” provisions in the will. OHIO REV. CODE § 1335.01.
59. Funding of a life insurance trust is accomplished by depositing securities, or other property yielding income, with the trustee and using the income of the trust to pay the life insurance premiums.
60. The insurance would be includable as insurance because the settlor of the trust would still retain incidents of ownership in the life insurance policies, CODE § 2042, or the assets of the trust itself would be includable in the full amount because the trust is revocable. CODE § 2042; Reg. § 20.2042-1 (c) (4) (1954). Cf. Estate of Newcomb Carlton, 34 T.C. 988 (1960), rev’d, 298 F.2d 415 (2d Cir. 1962).
61. CODE § 676.
benefit. This approach may offer flexibility in planning the estate, but there does not appear to be any immediate savings to be obtained by the wife in the area of federal income taxes. The use of a revocable insurance trust by the wife with policies on the life of her husband would not provide any estate tax benefits to the family different from outright ownership by the wife of insurance on the life of her husband.62

As to irrevocable life insurance trusts, the use of such a trust may provide estate tax savings in the family estate plan. The irrevocable trust is not funded and the settlor-insured transfers the policies to the trustee. There would be no retention by the settlor-insured of any incidents of ownership. The disposition of the proceeds would be according to the various provisions in the trust instrument. When the trust is set up, the settlor has made a taxable transfer as far as federal gift taxes are concerned.63 The valuation of that transfer would be governed by the general rules relating to the valuation of life insurance policies, as where, for example, the settlor assigns the policies directly to his wife.64 The continued maintenance of the premium payments by the settlor should not cause the proceeds of the insurance policies in the irrevocable trust to be taxable to the insured’s estate, since the payment of premiums on life insurance does not ipso facto cause the life insurance policies to be taxable to his estate.65 Upon the insured’s death, the trustee would collect the insurance proceeds and would proceed to distribute them pursuant to the terms of the irrevocable trust instrument.66 This procedure offers a potential saving in federal estate taxes to the estate of the settlor-insured, Mr. Baker, in our case. Further, if the wife predeceases her husband, the settlor-insured, she would not be deemed to own any part of this trust. However, in the trust instrument itself, there may have been created a type of property interest which the wife would own and which would be includible in her estate upon her subsequent death. For example, she may have been given certain rights over the trust, or a portion thereof, which would constitute a taxable power in her estate.67

MR. SUGARMAN: Mr. Kidder, you have discussed various forms of life insurance trusts. As I see it, these trusts are primarily methods of management of life insurance proceeds in a form other than keeping

62. See discussion at 332, supra.
64. See discussion at 331, supra.
67. CODE § 2041.
them in the policy. In other words, you have suggested the use of a
trust device for the distribution or payment of the insurance proceeds.

You have also indicated that in an irrevocable life insurance trust,
the proceeds of the insurance would not be includable in the estate of
Mr. Baker, the settlor-insured in this case, and also would not be includ-
able in his wife's estate if the wife has no powers over the irrevocable
trust.

Before proceeding further with other observations in this area, I
would like Mr. Cavitch, who is primarily concerned with the affairs of
Mr. Able's large estate, to bring into this discussion the estate and in-
heritance tax factors he feels are pertinent to our consideration of life
insurance programs.

ESTATE AND INHERITANCE TAX ANALYSIS
OF LIFE INSURANCE

MR. CAVITCH: A brief review of the fundamentals in this area is
desirable. When is insurance includable in the insured's taxable estate
for federal estate tax purposes? First, life insurance which is payable
to the insured's estate is automatically includable, without regard to any
other test, such as possession of incidents of ownership, payment of
premiums, or anything else. 88

Insurance on the insured's life is payable to his estate not only where
there is a direct payment by the insurance company to the executor of
the insured's estate, but also, for example, where the payment is made
to a surviving widow pursuant to a prior contract, or trust device, where-
by the insurance is committed to be used to pay estate taxes or other debts
of the insured. 89 In effect, this is a payment to his estate and would be
includable regardless of whether the insured owned the policy.

Secondly, insurance which is payable to beneficiaries other than the
insured's estate is includable in the insured's taxable estate if he possessed
any of the incidents of ownership in the policy at the time of his death. 70
Incidents of ownership include the right to change the beneficiaries, the
right to surrender the policy for its cash value, and the right to borrow
on the policy. 71 These are the three incidents of ownership that are most
commonly involved.

The possession by the insured of any one of these rights, or indeed any
other incident of ownership, will make the insurance proceeds includable
in his taxable estate, whereas the absence of all such rights in the insured
will remove at least a part of the proceeds from his estate. I say "a part"

68. Code § 2042(1).
70. Code § 2042(2).
because one always has the contemplation of death issue,\textsuperscript{72} with him particularly when life insurance is involved since it is a type of asset that is geared to death.

A further problem, with respect to contemplation of death, relates to premiums paid by the insured on insurance owned by another. Suppose that Mr. Able transfers a policy to Mrs. Able, or suppose that Mrs. Able has always owned a policy on Mr. Able's life, and the premiums are paid annually by Mr. Able. How does one treat, for estate tax purposes, the insurance proceeds which are paid on Mr. Able's death but which are attributable to the premiums paid by Mr. Able in the last three years? Mr. Able's estate may have a weak argument in contending that the premiums were not paid in contemplation of death.

MR. WOLF: Mr. Cavitch, if there is a danger in this area, perhaps it can be reduced by having the husband give funds to his wife each year out of which she can pay the premiums, rather than having the husband pay the premiums directly to the insurance company. Granted that in the three years immediately following the assignment of the policy to the wife, the federal government might successfully argue for the inclusion in his taxable estate of a proportionate part of the proceeds of the policy, if he should die in that period, but thereafter the gift is one of cash rather than an interest in an insurance policy.

MR. CAVITCH: I am inclined to agree, Mr. Wolf. One unanswered question is: If Mr. Able pays the premiums directly instead of giving the cash to Mrs. Able to pay them, are only the premiums paid within the last three years included in his taxable estate, or, as you say, is it a proportionate part of the proceeds?

MR. SUGARMAN: There has been discussion of this subject by some writers. However, in the eight-year period since the enactment of the 1954 Internal Revenue Code, the Treasury Department has given no indication that it would take the position that all or a portion of the insurance proceeds would be includable for federal estate tax purposes. Moreover, when there was the opportunity to do so in the Treasury Regulations under the estate tax, there was no indication that such a position would be taken. Do these facts indicate that the question is more theoretical than real?

MR. CAVITCH: No, and I cannot offer any explanation why there has been no further official statement on this subject.

MR. SUGARMAN: I personally would like to proceed on the basis that the Treasury Department has been aware of this question, and its silence is acquiescence in the position that only the actual gift — the amounts given or paid for premiums — is includable in the taxable es-

\textsuperscript{72} CODE § 2035.
This is assuming, of course, that the presumption of contemplation of death cannot be overcome. I believe that this is an area where the bridge has been crossed by the Treasury Department, and the issue should not be raised.

I suggest that we return to the matter of the federal estate tax in connection with insurance and the way in which insurance is qualified for the marital deduction. Mr. Cavitch, what are the particular problems in this area?

MR. CAVITCH: Your question involves the area of the most significant current litigation. In this area, however, most of the litigation can be avoided by proper planning.

Despite the increasing popularity of plans where the wife owns the insurance on the husband's life, in most cases the life insurance is still owned by the insured-husband. In that case, and particularly in Mr. Able's situation, it is going to be important that the maximum marital deduction be availed of.

With respect to qualifying insurance for the marital deduction, it should not be a difficult matter. A payment of insurance proceeds in one lump sum outright to the widow will normally qualify for the marital deduction. But even here one has to watch for some pitfalls.

The pitfall that is indicated in *Eggleston v. Dudley* involved a lump sum payment on the policy. The payment was conditioned on the wife surviving past the date on which proof of death was submitted to the insurance company. The question the court had to consider was whether that clause made her right to the insurance proceeds conditional, and conditional beyond a period of six months from the date of death. Since proof of death could be submitted well beyond six months from the date of death, if her right to receive the proceeds was conditioned on that event, she had a forfeitable interest that would not qualify for the marital deduction even though she did in fact live to receive the proceeds.

The court in the *Eggleston* case bailed out the estate by saying, in effect, "The policy terms are ambiguous, and we will resolve the ambiguity by considering what the intent of the insured was. And the intent was to qualify for the marital deduction." I think the case is wrong, but it is unnecessary to debate that point.

The point is that this whole problem can easily be avoided by making clear in the insurance policy — and most companies now do this as a matter of course — that proof of death simply conditions the date of payment, but does not condition the widow's right to receive payment. That is, even if she dies in the meantime her estate would receive the proceeds, not the secondary beneficiaries.

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73. 257 F.2d 398 (3d Cir. 1958).
74. Code § 2056(b) (6).
The more difficult litigation involves insurance proceeds which are not payable in one lump sum outright to the surviving wife, but rather are held on some form of insurance settlement option. Here the statute and Regulations clearly point out that if an option is selected the first payment of that optional settlement, whether it is a life annuity or interest payments with the proceeds being retained by the company, must be made within thirteen months after the death of the insured. And what is most troublesome, the widow must have a power exercisable "in all events" to appoint to herself, or to her estate, the proceeds retained by the insurance company.

If that power is in the form of a lifetime power to withdraw the proceeds, the insurance company will impose some limitations simply as a matter of convenience to it. What limitations will defeat the statutory requirement that the power be exercisable "in all events" is still uncertain.

The moral to be gained is that where the insurance is not going to be payable in one sum outright, but is going to be held by the insurance company on some optional settlement for the widow's benefit, the way clearly to qualify for the marital deduction is to give the surviving widow the power not simply to withdraw the funds during her lifetime, which involves these administrative convenience limitations in most situations, but a power to designate and to direct the insurance company that upon her death any amount still remaining will be payable to her estate. If that is done, then whether or not she has a right to withdraw funds during her lifetime, the proceeds will qualify for the marital deduction. I think it is a safer method.

MR. KIDDER: In such a case, Mr. Cavitch, if the widow is to receive installment payments under the policy rather than a lump sum payment of the proceeds, the installment payments made to the widow receive additional favorable tax treatment. The income portion of each installment payment of the life insurance proceeds normally is taxed as ordinary income to the beneficiary when received. If the beneficiary of the installment payments is the surviving spouse of the insured, this ordinary income portion is excludable from taxable income to the extent of $1,000 per year. To illustrate, take the case of a widow who is over age sixty-five and, therefore, is entitled to $1200 in exemptions. She may also be entitled to retirement income credits by reason of the fact

75. Code § 2056(b) (6); Reg. § 20.2056(b)-6 (1958).
77. Code § 101(d).
78. Code § 151(c).
that her husband was gainfully employed.\footnote{\textit{Code} \S 37 (b).} When the $1,000 exclusion as to the income portion of installment payments of life insurance proceeds is added to the picture, the widow may be able to receive substantial payment options under life insurance installment settlements before she is subject to income tax.

\textbf{Life Insurance and Charity}

\textbf{MR. SUGARMAN:} That is a good point on the income tax aspects. However, now I would like to move on to another matter.

Mr. Wolf has expressed some concern about the situation of Mr. Charles, who is only a ten per cent shareholder, but nevertheless a key executive.

We also have not talked extensively about Mr. Jonathan Dollar and his future interest in this company. What would happen to the company in the event these two men had to bail out the Ables and the Bakers?

The suggestion has been made that we explore the possibility of the Able Foundation acquiring stock in the corporation. Mr. Able, being a generous person, might like to contribute some stock to this or some other foundation; or perhaps the foundation could acquire, by gift or otherwise, some insurance on his life and buy some stock of the ABC Company upon Mr. Able’s death.

Mr. Wolf, have you considered the use of insurance in connection with charitable giving, and do you see any application here?

\textbf{MR. WOLF:} Insurance policies which have a built in cash surrender value after a considerable number of years of premium payments are like cash in the bank. And, as is true with cash, the policy can be given to charity. Further, the individual making the gift will be entitled to an income tax deduction for the policy value.\footnote{\textit{Ernst R. Behrend}, 23 B.T.A. 1037 (1931); \textit{Reg.} \S 25.2512-6 (1958); \textit{Rev. Rul.} 58-372, 1958-2 \textit{Cum. Bull.} 99.}

Also, after having given the policy to the charity, the donor can enable the charity to maintain the policy by making an annual gift to the charity in the amount of the annual premium. The donor, of course, would be entitled to a contribution deduction in the amount of the gift.\footnote{\textit{T.D.} 299, 1919-1 \textit{Cum. Bull.} 151; \textit{M. C. Adler}, 5 B.T.A. 1063 (1927); \textit{Eppa Hunton}, 1 T.C. 821 (1943).}

However, the income tax advantages of this type of charitable giving must be considered in connection with the effect such giving might have on estate taxes and, in particular, the marital deduction. For example, if instead of giving a life insurance policy to charity, the insured retains the policy and makes it payable to his estate, a larger marital deduction is obtainable because the estate is increased by the death proceeds of the
policy. The charity, on the other hand, will not be denied its benefit if the insured includes in his will a bequest to the charity in the amount of the death proceeds of the policy. Obviously, a careful analysis of the insured’s income tax status, the marital deduction aspects of his estate, and the current needs of the charity for funds must be made in determining the answer to the problem.

Also, if one is considering making a gift of a life insurance policy to a private charity, he should proceed with caution. If the private charity is lightly endowed and retains a policy of life insurance on which substantial premiums fall due and are paid each year, there is a danger that the Internal Revenue will view the policy as an improper investment of the charity and, thus, deny the charity its exemption.

Mr. Able, in this case, has a high premium policy in which the cash surrender value is greatly in excess of the amount of the premiums paid. If he were to cash this policy in, or if he were to sell it at its present cash surrender value, the amount of his gain would be taxed to him as ordinary income, not as capital gain. This is something that has to be watched, and it raises the question of what happens if one donates a nearly matured endowment policy to charity. Is it the same, from a tax standpoint, as the donation to charity of General Motors stock that was bought at twenty and is now selling at fifty? In that case, one does not realize any capital gain on the transaction. Will the same result follow, however, if one donates to charity an endowment policy which has a built-in gain? The Internal Revenue Service in Cleveland, Ohio, is currently taking the position that at the time of the charitable gift of the policy the donor realizes ordinary income in the amount of the excess of the value of the policy over his original basis. The issue, however, may have to be litigated.

MR. SUGARMAN: I believe you are referring to a policy such as the endowment policy that Mr. Able has which is nearing maturity.

MR. WOLF: Yes, I am.

MR. SUGARMAN: Would the case be different if the gift to charity was that of an ordinary life insurance policy which apparently has many years to go?

MR. WOLF: I think the only difference is that there is less gain built into that type of policy.

MR. SUGARMAN: I am inclined to feel that the nearness to ma-

82. Code § 2056.
83. Reg. § 1.504-1 (1962); Randall Foundation, Inc. v. Riddell, 244 F.2d 803 (9th Cir. 1957).
84. Code § 72(e).
turity might be a factor considered by the Internal Revenue Service on that matter. If we were to persuade Mr. Able to contribute some of his present insurance policies to a charitable organization, we probably should recommend that they be policies other than the endowment policy. What about the charitable organization maintaining those policies?

MR. WOLF: As I previously mentioned, the charitable organization could maintain the policies. Presumably, Mr. Able would be willing to continue contributing to the foundation the amount of the premium, for which he would receive a charitable deduction. The foundation in turn would pay the premium.

If the foundation itself pays the premium out of its own funds, then one has a question of whether it is being operated for charitable purposes, particularly if it is not a public community type foundation.

MR. SUGARMAN: Assume that Mr. Able pays the premiums, because he and the foundation desire that it continue its charitable work after his death. If the foundation has substantial insurance on Mr. Able’s life, what about the possibility of the foundation buying the ABC stock from the estate of Mr. Able?

Perhaps a solution to many of the problems that we have been discussing is to have a charitable foundation, with Mr. Charles, Mr. Baker, and Mr. Dollar as trustees, which will have insurance on the life of Mr. Able, and which will acquire the Able family stock in the corporation upon the death of Mr. Able. Of course, we may be able to persuade Mr. Able to leave a substantial block of that stock to the foundation by his will, particularly if Mrs. Able or the Able children are also trustees. 86

MR. CAVITCH: That kind of a device could presumably give Mr. Baker and Mr. Charles the amount of percentage control that they want, not through the retirement of stock and the uplifting of their percentage interest, but by being trustees of the charitable trust. On the other hand, they probably feel that they can cause the company to grow in value after Mr. Able’s death, and by giving the Able stock to the charitable foundation a proportionate amount of that increase in value will benefit the charity rather than themselves.

MR. SUGARMAN: To overcome the objection you raise, I suggest that some of the common stock be converted to a fixed value preferred stock before the foundation acquires it. As a matter of fact, such preferred stock may be a better investment for the foundation to hold. On the other hand, the executives holding common stock would have the benefit of the growth, or reduction, in the value of their equity interest based on their efforts.

SUMMARY

MR. SUGARMAN: To summarize, in this situation, involving a closely-held corporation with Mr. and Mrs. Able as the principal shareholders, there appears to be a need for a buy-sell agreement, and it was the consensus that it is advisable to have the corporation as the purchaser rather than the remaining shareholders. It was also generally agreed that the corporation should consider acquiring insurance on the life of Mr. Able to have the funds to meet all or a substantial part of the monetary requirements necessary for purchasing his stock upon his death. There was consideration given as to whether the purchase by the corporation of Mr. Able's stock should be mandatory or optional, but it was generally agreed that it should be mandatory, which makes the funding of the program by insurance all the more important.

We also considered the matter of the stock held by Mrs. Able, and it was agreed that arrangements should also be made for the disposition of Mrs. Able's stock upon the death of Mr. Able. There are some problems here, both from the standpoint of potential income tax to Mrs. Able and from the standpoint of the minority shareholders who may have differences of opinion as to whether the corporation or certain of the shareholders should purchase Mrs. Able's stock. This difference of opinion arises from the fact that the percentage interest of the minority shareholders may be affected, depending upon who purchases the stock.

In connection with these matters, toward the end of our discussion we considered the possibilities of a recapitalization of the corporation to divide the stock into common and preferred, with the possibility that the Able's stock interest might be converted into a fixed value preferred stock, some of which could be contributed to a charitable foundation. We also considered the possibilities of using insurance in connection with the foundation, with the view of acquiring additional stock from Mr. Able. We reached no conclusion on this matter, but it may warrant further consideration, assuming it is determined that such an investment by the foundation would be proper.

We also considered the use of insurance in connection with the younger executives of the company. A key man insurance program was considered as a means of providing some protection and incentive to Mr. Baker, Mr. Charles, and possibly Mr. Dollar. Such a program would provide a measure of security and also would make funds available for a deferred compensation arrangement for the key executives.

We also considered various forms of split-dollar insurance programs and concluded that this matter would be worth investigating, particularly for the younger executives of the corporation who could use the insurance protection but do not have a substantial income. Further considera-
tion should be given to the form of the split-dollar insurance program, particularly as to the ownership of the policy and the extent to which the spouse may acquire the term portion of the insurance.

A group insurance program was also considered. There are many advantages in a group term policy because of the deductibility of the premiums to the corporation and the fact that the premiums paid are not considered as income to the employees. Such a program is particularly valuable to the younger officers who can thereby acquire insurance protection without cost. However, Mr. Wolf warned us that abuses in this area could destroy its potential benefits.

We have also considered numerous aspects of ownership of insurance within the family, particularly the use of insurance trusts.

We have given overall consideration to the fact that company and personal insurance must dovetail with family and estate planning.

In the final analysis, there is obviously an important role which insurance plays in the business planning of a company such as the ABC Company and in the family and estate planning of the shareholders.

We have not considered many other facets of insurance planning, including the use of insurance in connection with pension trusts. These are broad fields that may or may not fit the situation of the ABC Company. Perhaps more important, the task still remains to determine the cost of the various insurance programs to the company and the individuals involved. Nevertheless, having agreed on the merits of some of these insurance programs, we can proceed to determine how they may be worked out in detail to meet the particular problems discussed.