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ESTATE PLANNING

Teaching Session

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This teaching session is for the actuary who would like a better understanding of the estate planning process from the point of view of the Advanced Underwriting Department of a large life insurance company.

At the beginning of the session, each participant received copies of several tax forms. Included were: United States Estate Tax Return Form 706; Instructions for Form 706; United States Quarterly Gift Tax Form 709; Instructions for Form 709; U.S. Fiduciary Income Tax Return Form 1041. These forms were referred to extensively during the session. Interested readers may obtain copies through their local Internal Revenue office.

MR. JAMES C. HARTWIG: When Pat and I were asked to give this presentation, we were told to assume that many of you have a complete and thorough understanding of life insurance company taxation but may not have had an exposure to the kind of tax planning necessary when a person puts his estate in order. We are hoping that you will look at the presentation in two ways. First, that you will view it as something personal, that is, you'll be acquiring some knowledge that will help you in thinking about your personal estate planning situation. Then we hope that you will look at it in a broader spectrum and say, "From a company viewpoint, if we have agents who want to operate in business and estate planning insurance markets, consider the kind of educational process that we have to go through with those agents." Understand why the agent has to go out and talk to people about the various kinds of taxes and the implications of these taxes.

My job will be setting the stage to acquaint you with the tax facts needed to operate in this planning area. We have put together an actual presentation. Pat will take you through a situation showing how the tax facts relate to a particular individual. Then we'll talk about some possible solutions to the clients' problems.

Let's start by looking at some of the tax problems. We will focus specifically on the federal estate tax and will highlight, briefly, the federal gift tax so that you understand their interrelationship. Finally, we will

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cover an area of income tax that you probably never even thought about - the area of income tax as it affects trusts and estates.

First, you have to distinguish between the federal estate tax and a state inheritance tax. The federal estate tax is a tax on the right to transfer property. All the assets that I own make up my gross estate. The federal government taxes my right to transfer assets out of that gross estate. The federal taxing authorities don't care who gets those assets. What they care about is the value of all those assets in the gross estate. The state inheritance tax authorities care about which assets come out of the estate and who ends up with the asset. That is the state inheritance tax which is levied on the beneficiaries' right to receive property.

A federal estate tax Form 706 must be filed for all estates where the assets exceed $60,000 at date of death. The form must be filed within 9 months after the date of death. The executor, appointed by the local court, has the responsibility for filing this return. There are statutory requirements for filing and penalties can be assessed for improper filing. All of the above requirements are covered in the Internal Revenue Service's Instructions for Form 706.

Let's take a look at the nature and kinds of property and assets that the federal government is concerned about when it levies a federal estate tax. Our focus will be on the United States Estate Tax Form 706.

Schedule A of Form 706 starts off with the real estate. Immediately understand that the executor has a problem assembling assets. He's now got the home in the country, the home in the city, and the raw real estate. The first thing that strikes you is the necessity for an appraisal. The appraisal of these assets at the date of death has to represent the fair market value of that asset. So, what is the home worth? Is it going to be the assessed value for local tax purposes? Does that have any relationship to fair market value? If it's income-producing property, how do you value that income stream from that apartment building? You can have some complicated kinds of real estate interests such as the man who leases his building to Penney's for 99 years, or an estate with a 1/24th interest in a Chicago Lake Shore high-rise. So the valuation of the real estate asset can present problems.

Now look at Schedule B, stocks and bonds. It's not difficult to value stock in the estate if it's IBM or General Motors. I go to the Wall Street Journal and pick up that value at date of death because I know the price at which stock traded over the counter or on the New York or American Exchange.

The area that I spent a great deal of my time on when I was with the Internal Revenue Service is the area of valuing the stock of the closely-held corporation. What is the fair market value of 200 shares of Widget Manufacturing that I own and that represent 50 percent of the private corporation? The factors that the government considers in the appraisal of that stock are the same factors that the investment banker considers or that you, as a reasonable prudent investor, would consider when you make a decision as to which stock you're going to buy on the New York Stock Exchange. These factors are outlined in Revenue Ruling 59-60.

The Revenue Ruling states the appraiser will want to know the nature and

history of the business. That probably involves an actual look at the building, walking through the plant and taking a look at the manufacturing process. What's the future of the product in this industry and this location? What's the economic outlook in general and in this industry? With interest rates going the way they are, how will interest rates affect this particular industry in this location.

Next, you'd look at the book value and the financial condition of that company. This is the point where you begin to analyze the profit and loss statement and the balance sheet. For example, what is the book value? Does the book value in this situation have any relationship to fair market value? If I'm in the manufacturing business, the book value may have no relationship at all to the fair market value of the stock. The earning capacity may be more important than the book value, particularly in a business involving a growing concern.

If a block of closely-held stock is small (minority interest), it might be claimed by the executor that no one would buy it because of its size. The Internal Revenue Service, however, can assume a hypothetical buyer and value the stock assuming such a buyer exists.

What about the dividend-paying capacity of this business? Does it pay dividends? Probably not, but does it have the capacity to pay dividends? Should the business owner really be taking $350,000 in salary or should part of that salary be considered dividend income? Does this business have any goodwill or intangible value? How do you attribute a value to my franchise from General Motors or my McDonald's franchise? Does that franchise continue at my death? Do I have the right to transfer that franchise to my family, or is it a contractual relationship that terminates on my death? Am I willing as a buyer to pay a premium for a particular business because of these intangible rights?

Are there any sales of this closely-held stock? If the sale is a 51 percent block, a buyer may pay a premium. How big is that block compared to all the shares outstanding in our business? Is it an arm's length sale or is it to my brother or sister? What are the people relationships involved? Does that sale represent the fair market value or, because of these relationships, is it a sham transaction?

All these factors then are considered in arriving at the fair market value of that closely-held stock. There can be some real differences of opinion on the fair market value. For example, my approach to value may be book value. You may take an earnings approach and, as a result, we may never meet. This kind of issue ends up in litigation. As you can see, the valuation of closely-held stock is a big problem.

In the case of closely-held stocks, two options present themselves at death: the stock can be retained for the deceased's family or it can be disposed of. It is in the latter case that buy-and-sell agreements, redemptions, and cross purchases are valuable. Generally, the value established in such an agreement will establish the fair market value for tax purposes. So a buy-and-sell agreement may make sense in a particular case to see if the value of a business interest can be fixed to avoid the hassle with the tax authorities.

The deceased's interests in mortgages, notes and cash have to be listed in Schedule C on Page 6.

Schedule D on Page 7 is used for listing life insurance on the decedent's life. I.R.C. Section 2042 controls the inclusion in the gross estate of insurance received for the benefit of the estate or insurance received by beneficiaries if a decedent held an incidence of ownership. Incidence of ownership includes the right of the insured or his estate to its economic benefit, to change the beneficiary, surrender the policy, revoke an assignment, or pledge it for a loan. Notice that the executor has to show the number of the policy, the name of the beneficiary, and the face amount. For every policy of life insurance listed in the schedule which constitutes a part of the estate, the executor must send a Form 712 which is completed by the insurance company.

Schedule E on Page 8 involves jointly-owned property. How do you hold the title to your home or real estate? Do you know that the law presumes, under I.R.C. Section 2040, that the first of the joint tenants to die is presumed to have furnished all the consideration for the purchase of that asset and, therefore, the full fair market value of that asset is included in the estate? The executor has the burden of gathering evidence to overcome that presumption.

Schedule F on Page 9 lists miscellaneous property including household goods, copyrights, patent rights, franchise rights, the right to judgement, and certain claims against particular individuals.

In Schedule G on Page 10, we're going to look at assets that have been subject to transfer. These are assets that have been transferred, but at the same time the decedent may have retained strings on the property itself. Schedule G also encompasses transfers in "contemplation of death." If I give an asset and die within 3 years after making that gift, it is presumed that that transfer was in contemplation of death and that asset goes back into my estate. I think most of you are aware of the general rules involving life insurance where the insured owner gifts a permanent life insurance policy more than 3 years before date of death and continues to pay the premiums. The courts have held that the amount of the premiums paid within 3 years of death would be included in the estate, but not the proceeds. When that insured owner makes a gift of an existing permanent life insurance policy within 3 years of his death and continues to pay the premiums, the Service at least is arguing that the entire proceeds are included in the estate. So life insurance, that asset that you own and have the right to transfer, can cause federal estate tax problems.

It may be interesting, in this contemplation of death area, to give you an insight into how these cases can go. In 1975 two cases came down. One is the Compton case. Basically, the facts were these. In October, 1969, this insured assigned ownership of his group term life insurance to his wife. This man had no adverse medical history and, in fact, the court found he was active in tennis, golf, swimming and skiing. He died in January, 1971, suddenly and unexpectedly, of a heart attack at age 46. The issue was whether the insurance should be included in his gross estate as having been a transfer in contemplation of death. The court found that it was. This is what they said: "The property in question (that group term insurance) was inherently death-oriented. The policies provided no present benefit in any form to this individual. (No cash values.) The evidence was insufficient

to establish a dominant controlling and compelling reason for the assignment of the policies unrelated to the possibility of death." So, with that kind of medical history and with that kind of age, the transfer was held to be in contemplation of death.

Another tax court case, the Zager case, was cited in 1975. Here the decedent had a stroke in 1959, a heart attack in 1961, diabetes in 1963, pancreatitis in 1963, acute colitis in 1964, and died on May 14, 1964. He made gifts between 1962 and 1964. Are these gifts included in his gross estate as having been a transfer in contemplation of death? The court held no. In this situation, when they looked at the facts, they found that there were living motives - he had an agreement with his son-in law to control the stock in the corporation.

As you can see, this is another area of controversy where the assets and transferring those assets can cause problems. If strings are maintained on those transferred properties, various Code sections pull them back into the estate. Trust instruments must be analyzed. Has the trust really been drafted properly or does the grantor, the person giving the property away, have too many strings to bring that property back into the estate?

Schedule H, Page 11, examines the powers of appointment. For example, consider a husband who transferred property in trust to his wife for her life. Imagine also that this wife has the power to consume the principal of that trust. Although she has a life estate, she also has power to control the principal. Therefore, she has a general power of appointment and the assets in that trust come into her estate.

Annuities are listed on the bottom of Page 11 in Schedule I. Many of these annuity arrangements are involved in the employer-employee relationships. If an interest passes on to my wife after I die, the annuity rights that she may have would be an asset in my estate.

Deductions from the estate are listed starting with Schedule J on Page 17. These include funeral expenses, administration expenses, attorney's fees, and executor's commissions.

Schedule M, Page 14, covers the very important area of the marital deduction. The marital deduction is contained in I.R.C. Section 2056. After I take off the allowable deductions from my total estate, it is possible for me to transfer to my spouse up to one-half of those assets free of federal estate tax. In order to qualify for the marital deduction, these assets must meet specific requirements for property passing to the spouse. If the spouse really doesn't have all the rights in the assets, the government may take part of it away, calling it terminable interest. Therefore, careful planning is important when deciding which assets to pass on to the spouse. As you know, I.R.C. Regulation 20.2056(b)-6 spells out the specific requirements regarding life insurance policies and the qualification of those policies for marital deduction purposes.

Finally, I have the right to give property to charity at death and thus receive charitable deductions. These are listed in Schedule N, Page 15.

Now that we've run through some of the sections of the federal estate tax return, how do I finally calculate the federal estate tax? Appendix 1 consists of an outline of an estate tax computation. This will show how the

tax structure works and how the assets discussed above fit into this flow.

Before we look specifically at that calculation, let us explore an interesting point about asset values. Assume I bought my ranch property for $100 an acre and it is selling for $2,000 an acre today. At my date of death, the basis of that real estate is stepped up to $2,000 an acre and that difference between the $100 and $2,000, in effect, is never subject to capital gains tax. At the present time in Congress, there is discussion about the taxation of that gain at date of death.

Now let us consider the particular tax example. Our individual didn't have any joint property and there were no transfers of property during his life. There were no powers of appointment. So, he had a total gross estate of $340,000. The funeral expenses, attorney's fees and executor's commissions were $15,000. There were outstanding debts of $5,000 and a $5,000 mortgage, so he had deductible expenses of $25,000. Under the marital deduction, he can pass one-half of his adjusted gross estate of $315,000 to his wife tax-free. Therefore, his total allowable deductions are $182,500, and he has a taxable estate of $97,500. The tables for computing the tax are found on Page 4 of the <u>Instructions for Form 706</u>. These rates apply to the gross estate. There is also a credit, per Table B, for the amount of inheritance tax that is paid to the state. Therefore, this estate has a $19,480 tax.

Tied in with the federal estate tax is the second tax fact - the gift tax. Let me just highlight a few things for you on the <u>Instructions for Form 709</u>. The gift tax applies to any gift by an individual of real or personal property whether tangible or intangible, and whether given directly to a donee in trust or by any other means. The tax is applicable to the gratuitous transfer of all types of property including real estate, securities, life insurance policies, annuities, contract rights, jewelry, art objects, and personal belongings.

Point number 1 tells us that if the asset's fair market value is more than $3,000, a gift tax return must be filed. If a husband and a wife make a gift to a third party, each is considered as making one-half. The first $3,000 of gifts to any donee during the calendar year is deductible in computing the amount of taxable gifts for a calendar quarter. That means if I can split the gift with my wife, a total of up to $6,000 is deductible.

There's a difference between the estate tax, where the basis is stepped up at the date of death, and the gift tax, where the donee takes the donor's basis. When I give stock in Widget Manufacturing to my son and my basis is $100 but the fair market value on the date of the gift is $2,000, the gift tax is levied on the fair market value which is $2,000. My son's basis in that stock is my basis, or $100 a share. He's got the stock, but if he sells it he's got the capital gains' problem.

Notice on Page 3 the marital deduction. One-half of the value of the property given to a donee who, at the time of the gift, was the donor's spouse may be deducted in computing the amount of taxable gifts for a quarter. So, the marital deduction also applies in the gift tax situation. Finally, on Page 4, there is the "Specific Exemption " - a lifetime specific exemption of $30,000, reduced by the sum of the amounts claimed or allowed in any other year. So, we're talking about two things: a specific exemption in my lifetime of $30,000 and an annual exclusion of $3,000.

The gift tax rate is three-quarters of the federal estate tax rate. It's a cumulative kind of tax meaning that it doesn't start off at the lowest bracket every year. A person who has a long history of making gifts has a gift tax bracket which continues to climb. However, when you're making gifts, you're taking that asset out of the highest federal estate bracket and putting it into the lowest gift tax brackets. So gifts continue to be a recommended technique of estate planning.

A final return that I think we should briefly take a look at is U.S. Fiduciary Income Tax Return Form 1041. The setting up of an estate or trust creates another taxpayer which presents many income tax planning possibilities. The fiduciary return serves as a sort of conduit. For example, funds distributed out of a simple trust are treated as a deduction on Form 1041 but appear as income on the beneficiary's Form 1040.

MR. PATRICK COLLOTON: Given this basic tax information, the estate planning process can be thought of as consisting of three steps. First, the case as we find it today must be analyzed. Assets must be inventoried and the will must be examined. Secondly, the problems which arise from this analysis must be found. Finally, a plan must be designed to solve these problems. Four problems which usually present themselves as a result of the case analysis and a hypothetical probate are: Excessive transfer costs; lack of liquidity; disposition of assets; family income.

Based on our fact finding, what kind of materials can we put together for an agent to analyze these kinds of estate planning problems? Appendix 2 shows a handout entitled "Confidential Electronic Estate Survey." Any number of life insurance companies have what they call their computerized estate survey or whatever. It's a big trend in the life insurance industry today to have a computerized electronic survey that your agents can order. They take the facts from the client, send in the data, and get back some output. This is a sample of the kind of output that our company would give you back with the survey.

Page 3 of this electronic survey summarizes the hypothetical family's current financial situation. The agent has been to see the client and has been able to gain the confidence of and establish sufficient rapport with the client to develop this fact-finding interview.

Page 4 is a hypothetical probate of what happens if John Q. Client dies today with his simple will leaving 100% to his wife. You will notice a gross estate of $1,012,000. That's a little bit higher than the asset page because when you start to determine the gross estate you forget about the debts. You just include all assets at their fair market value. The $93,000 of debts in his estate include the mortgage on his home, the mortgage on the summer cottage, and the note payable. Typical administrative expenses on an estate of this size are roughly $48,000. Even though we haven't done any estate planning, the mere fact that he's leaving everything to his wife entitles him to take advantage of the marital deduction. You don't have to do anything to maximize that except leave the property to your wife. He's entitled to deduct, however, only 50% of his adjusted gross estate or $435,600. Federal estate tax amounts to $97,953 and state death taxes payable, using a Wisconsin domicile, are $40,052. Therefore, he has to come up with about $280,000 in cash to pay off these debts, administrative expenses and taxes.

Some of you may have seen illustrations used by your salesmen that say, "debts the day before you die; debts the day after you die," which perhaps looked to you to be a little kooky. Well, in one sense it is, but it really isn't because all of a sudden you've got a big tax bill due. Most of us don't figure that we'll have any additional federal income taxes to worry about until next April 15th. If you happen to die and you are the owner of a large estate, however, you'll have a substantial tax bill certainly between now and next April. For this individual, his estate is suddenly subject to a levy of $280,000 payable within 9 months of his death.

This survey also indicates the completion of his probate. You'll notice we gave him a marital deduction of $435,600. That deduction passes directly to his wife under the column entitled "Jane." She receives the $435,600 plus whatever is left after those taxes and administrative expenses. Her total ending estate is $733,195.

What happens at her subsequent death, something that often gets overlooked in the estate planning process? Under this estate plan, his wife will have an estate of her own of $733,000. If she has not remarried, she is missing one of the prime requisites for a marital deduction, a surviving spouse. Therefore, the whole estate will be taxed. Administrative expenses, federal estate taxes, and state death taxes payable at her subsequent death total almost $240,000. This is after we have already been through a drain of about $280,000 at the husband's death.

Look at the bottom of the page. We started off with a proud, happy, American family that built a substantial business with a million dollars worth of assets. What will be left after the government, the attorneys, the accountants, and everyone else have taken their piece of the action? Only 49%, because 42% of this estate is going for federal estate tax, state death taxes and administrative expenses, and 9% for the payment of debts. That is what would happen to this individual if he possessed this estate with a simple will naming everything payable to his wife, and he died today with his wife dying subsequently without a spouse.

Page 5 shows the reverse situation where the wife dies first and he dies second. At the wife's first death she has no assets and virtually no cost at her death. Look at what happens to his estate. His estate is still $1 million, but without a surviving spouse the taxes and costs payable at his death are up appreciably. Note, however, that it still is less than what would happen if he died first and then she died second.

Page 6 shows how a very simple device can save a substantial amount of federal estate taxes. The hypothetical probate assumes we make only one change in John client's current estate. Instead of leaving everything to his wife, he leaves her exactly enough to qualify for the maximum marital deduction. The balance is left to the children with an income interest to the wife. Income is basically what she's looking for or what she needs anyway. The only thing we will not give her is the power to dispose of the principal. If she does not have the power to control the principal, it will not be included in her estate.

We've made a minor change in the will of John Client, but we haven't changed anything at his death. This is one of the hard lessons for individual clients to learn. Estate planning may not change what happens at his death all that dramatically. For example, the numbers here are exactly the same

as they were in our earlier illustration. Whether he leaves his wife 50% or 100%, he's entitled to the same marital deduction because the maximum is 50% of the adjusted gross estate.

The major change that we have made is at her subsequent death. Instead of her owning everything left over from his estate, he has passed close to $300,000 in trust to the children but has given her the total rights to the income from that. As long as she lives she'll get the income. Because she only has the income interest and not the power over the principal, only the marital deduction portion of $435,600 would be includable at her subsequent death, reducing her estate taxes substantially. Her estate taxes at her second death under this illustration would be $90,000. If you will refer back to Page 4, you will see that by leaving 100% to the wife the estate taxes payable on her second death would be $174,000. We have cut the ultimate estate tax payable at the wife's second death in half by making one simple change in the will.

Page 7 is simply an attempt to project the assets into the future, and give the client a feel for what his situation will then be like. In this case, we've chosen 15 years to age 60. I will leave this for you to pursue on your own. The point here is simply that the bigger the client's estate, the bigger the problem. The federal estate tax and most state death taxes are progressive, and liquidity problems will not necessarily be solved by a larger and larger estate. It will create a larger and larger liquidity need. We often try to show the client his projected estate out into the future simply to give him an idea that if he doesn't do something today, the problem is unlikely to go away. Simple growth alone won't solve his problems.

You will often hear your agents refer to a capital needs analysis. Pages 8 and 9 show a modified version of what is known in the industry as a capital needs analysis. Here we have taken the assets of this family and have divided them into two columns: a column that will list the liquid assets and a column called "net amount" that will list those assets which are not liquid.

We've put the checking account and the savings account over on the net side because it is very common for the client to say, "That's the little nest egg over there. I want that preserved." Any of you in this room that have been through a probate situation know that there are substantial cash drains immediately after death. Any existing small savings account or any money that's been built up in the checking account probably are going to be necessary just to pick up those initial cash drains such as medical expenses, additional transportation costs, and funeral expenses. Don't count on those savings to meet the ultimate tax costs because they probably won't be there. Miscellaneous securities have been put in the liquid column because the client said to sell them off at his death. The client has told the agent that he would like the mortgages on his residence and summer cottage paid off so that his family can continue to live in and use them. Personal property such as furnishings and automobiles just aren't liquid by nature.

What do we do with the Client Corporation? We're going to hold it for a while since selling it creates all sorts of unique problems in and of itself. The client also desires that his family maintain control of his investment real estate. Although it is only worth $50,000 today, it is in the path of the expressway and may be worth millions in the future. Of course, the group term and permanent life insurance is available for estate liquidity

needs.

If you look at the assets that are either available for liquidity or that he wants to have sold and you take away the mortgages and the note payable that he wants to have paid off, there is not much left.

Let's take a look at Page 9. This is where the client starts to see that maybe some of his ideas and his objectives are not realistic. We saw earlier that if this particular client were to die today, he needs $186,000 to settle his estate. This includes federal estate taxes, state death taxes and administrative expenses. Debts are not included since they have already been taken out on Page 8. He said he needed a $56,000 fund to provide for the education of his four children. From Page 8, there's $23,000 in cash that will be needed for the payment of the debts, leaving a total shortage of $265,000.

Capital for estate liquidity is only part of his problem. After paying off the taxes and expenses, his family has to eat and be able to exist. He said he would like to have his family be able to get $35,000 a year. It seems like a lot of money, but he's currently earning $60,000 a year. That requires capital of $580,000 assuming 6% earnings each year. If all I was worried about was one or two more years, I could probably assume a much higher rate of return than 6%. For purposes of illustration only, we've picked 6%.

Part of the need will be offset by Social Security. For purposes of our electronic estate survey, we capitalized the Social Security benefit at $64,000. There is also a little income coming from the savings account which we've capitalized. The total need is, therefore, $514,000 for family income.

Adding it all up, if this fellow were to die today, he would have to be able to come up with $779,000 of cash or capital to accomplish his family objectives. What will often happen in a situation like this is that an agent will go back to the client with this as a talking point. This need will probably come out to be substantially different than what the client eventually agrees with his attorney and his accountant as to what his ultimate need is for capital. The analysis is just a starting point. A good agent knows, as any estate planner knows, that this individual's objectives were unrealistic from the start. There is no way, given the makeup of this estate and the current existence of the federal estate and state death taxes, that he can preserve that three-quarters of a million dollar business. It can't be done. But the whole point of an estate plan is to go back and show the client what it costs to accomplish his personal objectives so that he can then make the tough decision between his personal decision-making process and his needs.

The process of the sale begins to evolve when the client takes his innermost desires and needs and measures the cost that he's going to have to pay to realize those objectives. The figures on Page 9 are not precise but only have to serve as guideposts in this process. Contrary to the opinion of many, the client doesn't use the numbers on the page as a basis for buying. He looks at numbers on pages like this for general concepts. We have a difficult time teaching our agents that the numbers on the page, to the nickel, really aren't that important. There is an indication of a substantial need, whether it's $700,000, $500,000, or $300,000 doesn't matter.

Given the need, what kinds of options does the client have available? The easy option is to go out and buy enough life insurance. If he went out and bought $700,000 worth of life insurance, he could do it. He probably can't afford that amount of life insurance, so he's got to look for alternatives.

Why does life insurance play a role in estate planning? For very obvious, but often overlooked, reasons. It's the only asset that pays off 100 cents on the dollar at precisely the moment you need it. The federal estate tax is due and payable when you die. By coincidence, that's when your life insurance policy pays off. Life insurance and estate planning go beautifully hand-in-hand. A number of solutions are available.

Personal life insurance can be a solution to the problem. The individual could buy and own a policy on his own life naming his wife as beneficiary. This has the advantage of allowing the client complete control over the policy. The disadvantage of personally-owned life insurance is that, if the client owns the policy, it's going to be includable in his estate and the solution has now become a part of the problem. However, if his wife owns the policy, her estate will ultimately be increased. Although the half-a-million dollar policy will not be includable in his estate when he dies, it will ultimately increase her estate at her subsequent death. We have solved the liquidity problem at his death without increasing his estate, but we have now had the proceeds go into his wife's estate and somewhere down the line those proceeds are going to be subject to estate tax at our generation again.

A third alternative would be to have it skip our generation completely. We could have that policy owned by an irrevocable trust for the benefit of our children, or if we had adult children, we might have them own the policy on our lives. The advantage of having an irrevocable trust or adult children own the life insurance policy on one's life is obvious. It doesn't get included in the estate and is not subject to the federal estate taxes of his wife or himself. It skips being taxed in their generation and will flow directly to their children free of federal estate tax. The obvious disadvantage is that he no longer has any control or rights in a policy placed in an irrevocable trust. Any financial bind that he gets into, any reasons to change beneficiaries, to get to the cash values, or to take any action with respect to that policy is beyond his control. As somebody once said, "The only problem with an irrevocable gift is that it's irrevocable."

What about some business solutions? I'm the owner of a closely-held business. Can I somehow use my business to solve the problem? Yes, I probably can. For example, my corporation could apply for and be the owner of a life insurance policy on my life sufficient to redeem all of my stock at my death. If my stock is worth three-quarters of a million, the corporation can take out a key-man policy on my life for that amount. A stock redemption agreement will be made between my corporation and the two shareholders involved which says that whenever a shareholder dies, the corporation will redeem and the executor will sell all shares of stock in that corporation. When I die, the corporation takes the three-quarters of a million dollars in cash and buys the stock from my estate. The advantage: You've escaped, first of all, the capital gains on that stock ownership. You've heard about the stepped-up basis at death. Assume the stock had a cost basis of one hundred dollars and is now worth three-quarters of a million. If I sold that during my lifetime, I'd pay a capital gains tax on the gain. If I hold

it until death, the stock takes on a new basis which is fair market value at the date of death.

An insured stock redemption agreement is a great way to have closely-held corporate stock converted into cash, but it overlooks the need of the individual business owner to have members of his family continue on in that business. To provide for such a need, a Section 303 redemption can be used. My corporation buys a key-man life insurance policy on my life. The corporation is the applicant, owner, and direct beneficiary. At my death, the corporation will redeem, from my estate, enough stock to equal the taxes and administrative expenses. A special provision in the Internal Revenue Code, Section 303, allows for that kind of a redemption to be done on a tax-favored basis. I think a discussion of Section 303 would be beyond the scope of our meeting here today, but it is an effective way of having part of the stock redeemed by the corporation.

Although Section 303 redemptions are excellent estate planning tools, they do have one major problem. If a corporation has two equal shareholders, and one dies, what is left after the redemption? Part of the deceased's stock will have been redeemed and his family will now own a minority interest in that corporation. The minority interest in a closely-held corporation is seldom worth more than the paper the stock shares are written on for obvious reasons. A minority shareholder has virtually no rights and the corporation is controlled exclusively by the whims of the majority shareholder.

The corporation, of course, needs cash to provide for any of these redemptions. That's where life insurance comes in. Most closely-held corporations are operating under a continuous cash flow problem. Most are grossly undercapitalized, and any kind of interruption to their working capital will cause that corporation severe problems. They just do not have the books to get to the banks to get the kind of loans that larger corporations can get. That's why so much life insurance is sold to closely-held corporations. The cash will come in to accomplish these redemption needs without interfering with the cash flow and working capital of that corporation.

What other possible solutions do we have? A qualified pension or profit-sharing plan would be a good insurance solution for this individual. A qualified pension or profit-sharing plan using life insurance as an elective purchase or as a regular part of the plan could provide substantial values. The plan would provide a build-up of retirement income on a tax-favorable basis for the client and the life insurance owned in that qualified plan will provide an excellent solution to his current liquidity needs. Why? Because life insurance in a qualified plan enjoys a special estate tax exclusion. Life insurance owned by a qualified plan and payable at the death of the plan participant is not includable in the participant's estate for federal estate tax purposes. I could set up a qualified plan for this individual based on his salary of $60,000 and a money purchase pension contribution. We figure, just roughly, that we could generate about $250,000 of life insurance on this client in his qualified pension plan which would not be includable in his estate.

What about split-dollar life insurance? Split-dollar life insurance is really nothing more than personally owned life insurance with my corporation paying the premium. The corporation will recover at my death its investment in the contract and my beneficiaries will receive the balance of the

proceeds. Section 79, group permanent life insurance, is another potential solution. When you strip away all of the verbiage, Section 79 is nothing more than personally-owned life insurance for the owner-key executive of the closely-held corporation paid for by the corporation with tax-deductible dollars. That's all it is, and don't think for a second that it has any market appeal other than that.

The potential insurance solutions to this individual's problem, whether it's $700,000, $500,000 or $300,000, are all ways in which life insurance can generate capital for our client. That's why your agents and our agents are so interested in the estate planning market. Life insurance is an ideal planning tool for the individual with the large estate or for the closely-held corporation owner who has the same problems but who has a unique tool, the corporation, to help him solve the problems.

It has often been asked, "How can an individual with a million dollar estate have a liquidity need?" The best way to answer that would be to think through your own situation. Make up a little balance sheet and add up all of the assets that you have today. Would it be a problem if you had to convert about a third of your family assets to cash? It probably would. It's a problem, and the larger the estate, the larger the problem. There is only one way to effectively avoid federal estate taxes, and that's to give it all away, and there are few people who are willing to do that. Will planning, trust planning, and other devices can minimize federal estate taxes, but giving everything away is the only way to eliminate them.

APPENDIX 1

Hypothetical Estate Tax Calculation

SCHEDULE		VALUE AT DATE OF DEATH
A	Real Estate	$ 30,000
B	Stocks and Bonds	200,000
C	Mtg.'s, Notes, Cash	20,000
D	Insurance	85,000
E	Jointly Owned Property	
F	Miscellaneous Prop.	5,000
G	Transfers During Life	
H	Powers of Appointment	
I	Annuities	
	TOTAL GROSS ESTATE	$340,000
F	Funeral and Administration Expenses	15,000
K	Debts	5,000
	Mortgage	5,000
	TOTAL	$ 25,000

ASSUME: Maximum Marital Deduction which is ½ the Adjusted Gross Estate

Total Gross Estate	$340,000
Allowable Deductions	- 25,000
Adjusted Gross Estate	$315,000

Maximum Marital Deduction is ½ or $157,500

Total Allowable deduction is		182,500
25,000 + 157,500 = $182,500		
Total Gross Estate		340,000
Total Allowable Deduction	$182,500	
Exemption	60,000	
Total Deduction + Exemption		-242,500
TAXABLE ESTATE		$ 97,500

TAX PER TABLE A

$60,000		$ 9,500
+ 37,500	is	+ 10,500
$97,500		$20,000

CREDIT PER TABLE B

$90,000	is	$400.00
+ 7,500		+ 120.00
$97,500		$520.00

GROSS ESTATE TAX (TABLE A)	$ 20,000
CREDIT FOR STATE DEATH TAX (TABLE B)	- 520
NET ESTATE TAX PAYABLE	$ 19,480

APPENDIX 2 - PAGE 1

CONFIDENTIAL

ELECTRONIC ESTATE SURVEY

PREPARED FOR JOHN Q CLIENT

BY NML

DATE MAY 1976

APPENDIX 2 - PAGE 2

BASED ON THE FACTS AND INFORMATION YOU HAVE GIVEN US WE HAVE PREPARED THIS ELECTRONIC ESTATE SURVEY.

THIS SURVEY PRESENTS APPROXIMATE ESTIMATES OF ESTATE COSTS. THE ASSUMPTIONS, FACTS REGARDING ASSET VALUATIONS, PROPERTY OWNERSHIP AND ESTATE PROJECTIONS ARE BASED ON THE INFORMATION YOU SUPPLIED IN THE FACT FINDING INTERVIEW. THIS ELECTRONIC ESTATE SURVEY IS NOT DESIGNED TO GIVE YOU LEGAL OR TAX ADVICE. YOU MUST RELY UPON YOUR ATTORNEY FOR COUNSEL WITH RESPECT TO LEGAL AND TAX MATTERS.

THIS SURVEY CONSIDERS THE FOLLOWING QUESTIONS -

1. WHAT IS THE VALUE OF YOUR ESTATE

2. ARE THERE ENOUGH LIQUID DOLLARS IN YOUR ESTATE TO COVER ESTATE COSTS

3. WHAT INCOME WILL YOUR ESTATE PROVIDE FOR YOUR FAMILY TODAY

APPENDIX 2 - PAGE 3

SUMMARY OF FAMILY ASSETS

ASSET	OWNER	VALUE TODAY	PROJECTED VALUE IN 15 YEARS
CASH-CHECKING	JT	2,000	2,000
CASH-SAVINGS	JT	5,000	
MISC SECURITIES	JT	15,000	25,000
RESIDENCE	JT	75,000	100,000
MORTGAGE ON RESIDENCE	JT	-35,000	-10,000
SUMMER COTTAGE	JT	25,000	35,000
MORTGAGE ON SUMMER COTTAGE	JT	-18,000	-9,000
PERSONAL PROPERTY & AUTOS	HD	15,000	15,000
FURNISHINGS	HD	20,000	20,000
J Q CLIENT CORPORATION	HD	750,000	1,500,000
INVESTMENT LAND	HD	50,000	250,000
NOTE PAYABLE	HD	-40,000	
GROUP TERM LIFE	HD	30,000	30,000
PERMANENT INS	HD	25,000	25,000
NET FAMILY ASSETS		919,000	1,983,000

HYPOTHETICAL ESTATE SETTLEMENT ASSUMES JOHN Q DIES FIRST 100% TO JANE
COSTS PROJECTED 0 YEARS

	JOHN Q	JANE
ESTATES	$ 1,012,000	$ 0
DEBTS	-93,000	
ADMINISTRATION	-47,800	
MARITAL DEDUCTION	-435,600	435,600
GIFTS TO CHARITY	0	
FEDERAL TAXES	-97,953	
STATE DEATH TAX	-40,052	
NET ESTATE	$ 297,595	
AMOUNT TO SPOUSE	-297,595	297,595
AMT TO OTHER HEIRS	0	
ENDING ESTATES	$ 0	$ 733,195

------------------------AT DEATH OF JANE ------------------------

	OTHERS	JANE
ESTATES	$ 0	$ 733,195
DEBTS		0
ADMINISTRATION		-39,659
GIFTS TO CHARITY		0
FEDERAL TAXES		-174,696
STATE DEATH TAX		-25,214
NET ESTATE		$ 493,626
AMT TO OTHER HEIRS	493,626	-493,626
ENDING ESTATES	$ 493,626	$ 0

TOTAL OF TAXES AND EXPENSES FOR BOTH ESTATES $ 425,374

AMOUNT OF ESTATE TO TAXES AND EXPENSES 42.03%

HYPOTHETICAL ESTATE SETTLEMENT ASSUMES JANE DIES FIRST 100% TO JOHN Q
COSTS PROJECTED 0 YEARS

	JANE	JOHN Q
ESTATES	$ 0	$ 1,012,000
DEBTS	0	
ADMINISTRATION	-3,000	
MARITAL DEDUCTION	0	0
GIFTS TO CHARITY	0	
FEDERAL TAXES	0	
STATE DEATH TAX	-1	
NET ESTATE	$ -3,001	
AMOUNT TO SPOUSE	3,001	-3,001
AMT TO OTHER HEIRS	0	
ENDING ESTATES	$ 0	$ 1,008,999

------------------------AT DEATH OF JOHN Q --

	OTHERS	JOHN Q
ESTATES	$ 0	$ 1,008,999
DEBTS		-93,000
ADMINISTRATION		-50,699
GIFTS TO CHARITY		0
FEDERAL TAXES		-227,727
STATE DEATH TAX		-32,185
NET ESTATE		$ 605,388
AMT TO OTHER HEIRS	605,388	-605,388
ENDING ESTATES	$ 605,388	$ 0

TOTAL OF TAXES AND EXPENSES FOR BOTH ESTATES $ 313,612

AMOUNT OF ESTATE TO TAXES AND EXPENSES 30.98%

HYPOTHETICAL ESTATE SETTLEMENT ASSUMES JOHN Q DIES FIRST 50% TO JANE
COSTS PROJECTED 0 YEARS

	JOHN Q	JANE
ESTATES	$ 1,012,000	$ 0
DEBTS	-93,000	
ADMINISTRATION	-47,800	
MARITAL DEDUCTION	-435,600	435,600
GIFTS TO CHARITY	0	
FEDERAL TAXES	-97,953	
STATE DEATH TAX	-40,052	

NET ESTATE	$ 297,595	
AMOUNT TO SPOUSE	0	0
AMT TO OTHER HEIRS	-297,595	
	-------------	-------------
ENDING ESTATES	$ 0	$ 435,600
	*************	*************

------------------------AT DEATH OF JANE --

	OTHERS	JANE
ESTATES	$ 297,595	$ 435,600
DEBTS		0
ADMINISTRATION		-24,780
GIFTS TO CHARITY		0
FEDERAL TAXES		-90,816
STATE DEATH TAX		-11,385

NET ESTATE		$ 308,619
AMT TO OTHER HEIRS	308,619	-308,619
	-------------	-------------
ENDING ESTATES	$ 606,214	$ 0
	*************	*************

TOTAL OF TAXES AND EXPENSES FOR BOTH ESTATES $ 312,786

AMOUNT OF ESTATE TO TAXES AND EXPENSES 30.90%

HYPOTHETICAL ESTATE SETTLEMENT ASSUMES JOHN Q DIES FIRST 50% TO JANE
COSTS PROJECTED 15 YEARS

	JOHN Q	JANE
ESTATES	$ 2,002,000	$ 0
DEBTS	-19,000	
ADMINISTRATION	-96,300	
MARITAL DEDUCTION	-943,350	943,350
GIFTS TO CHARITY	0	
FEDERAL TAXES	-252,512	
STATE DEATH TAX	-107,418	

NET ESTATE	$ 583,420	
AMOUNT TO SPOUSE	0	0
AMT TO OTHER HEIRS	-583,420	
	-------------	-------------
ENDING ESTATES	$ 0	$ 943,350
	*************	*************

------------------------AT DEATH OF JANE --

	OTHERS	JANE
ESTATES	$ 583,420	$ 943,350
DEBTS		0
ADMINISTRATION		-50,167
GIFTS TO CHARITY		0
FEDERAL TAXES		-236,705
STATE DEATH TAX		-33,337

NET ESTATE		$ 623,141
AMT TO OTHER HEIRS	623,141	-623,141
	-------------	-------------
ENDING ESTATES	$ 1,206,561	$ 0
	*************	*************

TOTAL OF TAXES AND EXPENSES FOR BOTH ESTATES $ 776,439

AMOUNT OF ESTATE TO TAXES AND EXPENSES 38.78%

APPENDIX 2 - PAGE 8

PRESENT SUMMARY OF ESTATE AT DEATH OF JOHN Q

NAME OF ASSET	TOTAL AMOUNT	LIQUID %	LIQUID AMOUNT	NET AMOUNT	INCOME %	ANNUAL INCOME AMOUNT
CASH-CHECKING	2,000	0	0	2,000	.00	0
CASH-SAVINGS	5,000	0	0	5,000	5.00	250
MISC SECURITIES	15,000	100	15,000	0	.00	0
RESIDENCE	75,000	0	0	75,000	.00	0
MORTGAGE ON RESIDENCE	-35,000	100	-35,000	0	.00	0
SUMMER COTTAGE	25,000	0	0	25,000	.00	0
MORTGAGE ON SUMMER COTTAGE	-18,000	100	-18,000	0	.00	0
PERSONAL PROPERTY & AUTOS	15,000	0	0	15,000	.00	0
FURNISHINGS	20,000	0	0	20,000	.00	0
J Q CLIENT CORPORATION	750,000	0	0	750,000	.00	0
INVESTMENT LAND	50,000	0	0	50,000	.00	0
NOTE PAYABLE	-40,000	100	-40,000	0	.00	0
GROUP TERM LIFE	30,000	100	30,000	0	.00	0
PERMANENT INS	25,000	100	25,000	0	.00	0
TOTAL	919,000		-23,000			250

APPENDIX 2 - PAGE 9

PRESENT ANALYSIS OF CAPITAL NEEDS AFTER DEATH OF JOHN Q

1. CAPITAL NEEDED FOR ESTATE LIQUIDITY

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  185,805   TO SETTLE ESTATE -- EXCLUDES NEED IN ESTATE OF SPOUSE
   56,000   FOR FAMILY OBJECTIVES-        0 MORTGAGE    56,000  EDUCATION        0 OTHER NEEDS

  -23,000 AVAILABLE IN ESTATE
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  264,805   NEW CAPITAL NEEDED FOR ESTATE LIQUIDITY
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2. CAPITAL NEEDED FOR FAMILY INCOME

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  583,333   NEEDED FOR $     2,916 MONTHLY INCOME -- ASSUMES  6% RETURN

   64,537 SOCIAL SECURITY - PRESENT VALUE OF MOTHER AND CHILD BENEFITS AT  6%
    4,166 ESTATE AFTER MEETING LIQUIDITY NEEDS -- ADJUSTED TO  6%
-----------
  514,630   NEW CAPITAL NEEDED FOR FAMILY INCOME
```

3. SUMMARY OF CAPITAL NEEDED

	OUTSIDE ESTATE		ADD TO ESTATE
CAPITAL FOR LIQUIDITY	264,805	OR	331,835
CAPITAL FOR INCOME	514,630	OR	612,654
	-------		---------
TOTAL NEED	779,435	OR	944,489