1. List the five most common objectives of using life insurance in an estate plan.
The five most common objectives of using life insurance in an estate plan are as follows:
   • Protecting the income stream of the client's family.
   • Providing liquidity at the insured's death.
   • Providing a source of retirement income.
   • Funding the children's education.
   • Creating or sustaining family wealth.

2. When selecting the amount of life insurance needed to protect the income stream of beneficiaries, what should be considered?
When selecting the amount of life insurance needed to protect the income stream of beneficiaries, the following should be considered:
   • The annual income needed by the family.
   • The family's outstanding debt.
   • The need to replace the income of the decedent.
   • Any extra expenses that a surviving spouse may incur since the decedent's domestic services will no longer be available to the family.

3. What is the advantage of paying off debt at the death of the first spouse?
The surviving spouse will not have the burden of servicing an outstanding debt. Without this burden, monthly expenditure requirements are lessened, and if the surviving spouse is not skilled at managing his finances, paying off debt provides some protection against future financial problems.

4. How is life insurance included in a plan for funding college education?
Many parents want to help their children by providing them with the funds necessary to attend college. Usually, parents will develop a plan to contribute a certain amount, monthly or yearly, to an account or an Education IRA. The necessary contribution is calculated based on the number of years until the child begins attending college, and each contribution must be made to provide the child with the planned amount for col-
lege. If one parent dies before completing the funding, the contribution may become too much of a financial burden, or may be overlooked by the surviving parent. Life insurance can be used to provide the funds necessary to continue funding the contribution, or it can be used as a lump sum funding equal to the difference between the amount funded before the parent's death and the remaining amount necessary.

5. **Why is liquidity an issue when a decedent’s assets pass through the probate process?**
   Because a decedent's property may have to go through the probate process, it can take several months for the family to actually receive the property. During those months of waiting, the family will need cash to pay the mortgage, buy clothes for the children, pay private school tuition, and keep food on the table. The family may also need cash to pay the funeral expenses and last medical expenses of the decedent. An insurance company pays the beneficiary of a life insurance policy upon presentation of the death certificate. Although this process is not instantaneous, it is usually much quicker than the probate process and will provide the family with the necessary cash.

6. **Why is liquidity an issue for a large estate?**
   A large estate is often comprised of a few, or even one, large asset. Commonly, the asset is an interest in a closely held business whose appraised fair market value is much greater than any other asset, and whose large value is based upon future earnings and the value of the company's fixed assets. Consequently, the federal estate tax, and any corresponding state estate or inheritance tax, is calculated including this fair market value, even though the value cannot be used to pay the estate taxes due. (You cannot pay estate taxes with fixed assets or future earnings.) Within nine months of the decedent's death, his estate will be required to pay the estate taxes. To avoid having to quickly sell the company's assets, which may create income tax consequences, a life insurance policy can be used to fund the cash necessary to pay the estate taxes.

7. **How can life insurance provide financial security for a surviving spouse in retirement?**
   Usually throughout an individual's life, he contributes to various savings mechanisms to provide income for himself and his spouse during his retirement. If an individual dies before his goal has been fully funded, a shortfall may result for the surviving spouse. Life insurance can provide a lump sum at a decedent's death that will provide needed retirement income for the surviving spouse.

8. **How can life insurance fund retirement needs while the insured is still alive?**
   If a cash-value policy is purchased, and the premium is paid on a regular basis, the policy cash value will grow over time. At retirement, if the insured's estate will not have liquidity needs, or need the life insurance proceeds for other purposes (as discussed above), the insured can take tax-free distributions of basis and take loans from the cash value of the policy to supplement retirement income. All of this assumes that the insured is also the owner of the policy, a situation that is usually avoided in estate planning because it will cause the proceeds of the policy to be included in the insured owner's federal gross estate.

9. **List the basic types of life insurance.**
   The basic types of life insurance are term insurance, universal life insurance, whole life insurance, and variable universal life insurance.

10. **Define a term life insurance policy.**
    A term life insurance policy is a life insurance contract that states that if the insured dies within the term of the contract, the insurance company will pay a stated death benefit.
11. Why is the premium on a term insurance policy lower than the premium on a permanent policy?
The premium on a term insurance policy is lower than the premium on a permanent insurance policy because the term insurance policy has a level premium for a fixed term, which is a period in which it is less likely that the policyholder will prematurely die. The fixed term is shorter than the life term for permanent insurance. The premium on a term insurance policy reflects the actuarial risk that the insured will die during the term of the contract. Other types of permanent insurance include an amount within the premium that is allocated to a savings account.

12. Why is the strategy of “buy term and invest the difference” not an optimal strategy for people who have a permanent need for life insurance protection?
When an individual has a permanent need for life insurance protection, buying term and investing the difference can be a disaster. As the individual gets older, the premium of the term policy will rise exponentially. At advanced ages, the annual cost of the insurance policy may be prohibitive, and if the premium is not paid, the insurance will lapse.

13. How is a term insurance policy used when an estate plan includes a GRAT?
If the grantor dies within the estate tax inclusion period of the GRAT, the fair market value of the assets within the GRAT will be included in the decedent’s (grantor’s) federal gross estate. The inclusion of the assets will create additional estate tax due (potentially equal to 45% of the fair market value of the assets), but the assets will physically transfer to the beneficiaries of the trust per the trust document. The assets do not revert to the grantor’s estate. The grantor can purchase a term insurance policy with a term equal to the estate tax inclusion period, and a face value equal to the federal estate tax that would be created by the inclusion of the GRAT’s assets at a lower premium cost than 45% of the fair market value of the GRAT’s assets. So, if the grantor dies within the estate tax inclusion period, the term insurance policy will provide the cash necessary to pay the additional federal estate tax due.

14. How does a universal life insurance policy differ from a term life insurance policy?
Unlike a term insurance policy, a universal life insurance policy has a cash accumulation account. The cash accumulation account grows tax-deferred and in any given year, the owner of the policy can decide to reduce his premium payment by the value of the cash accumulation account.

15. What guarantee does the insurer give the insured under a whole life insurance policy?
The insurer guarantees that the life insurance policy will remain in force as long as the insured pays a stated premium each year.

16. How is the cash value of a whole life insurance policy invested?
The cash value of a whole life insurance policy is invested in the bond portfolios of the insurer.

17. In general, how does a variable universal life insurance policy differ from a universal life insurance policy?
A variable universal life insurance policy allows the insured to choose how the cash account is invested. The cash account of a universal life insurance policy is invested in the bond portfolios of the insurer.

18. Identify the parties to a life insurance policy.
The owner, the insured, and the beneficiary of the policy.
19. **In the event that a life insurance policy does not have a named beneficiary, who receives the death benefit?**
   In the event that a life insurance policy does not have a named beneficiary, the owner of the policy will receive the death benefit.

20. **Briefly describe the transfer-for-value rule.**
    If a life insurance policy is transferred for valuable consideration, the death benefit in excess of the transferee’s adjusted basis will be subject to income tax.

21. **List the exceptions to the transfer-for-value rule.**
    The transfer for value rule will not apply when there is a transfer of the policy to any of the following individuals:
    - The insured,
    - A partner of the insured,
    - A partnership in which the insured is a partner,
    - A corporation in which the insured is a shareholder or officer, or
    - A transferee who takes the transferor’s basis in the contract.

22. **List the settlement options available for life insurance policies.**
    The beneficiary of a life insurance policy can choose among the following settlement options:
    - Lump sum death benefit,
    - Leave the life insurance proceeds on deposit with the insurer and receive interest income, or
    - Annuity option.

23. **Discuss the tax consequences to a beneficiary who chooses to leave the life insurance proceeds on deposit at the insurer.**
    A beneficiary who chooses to leave the life insurance proceeds on deposit with the insurer will receive interest income that accrues on the balance of the proceeds. The interest income will vary depending upon the amount of the proceeds and the prevailing market interest rates. This interest income is taxable to the beneficiary, but the balance of the proceeds will remain nontaxable, provided the policy was not subject to the transfer for value rule.

24. **How is the surrender value of a life insurance policy calculated?**
    The surrender value of a life insurance policy is the amount an owner will receive if he surrenders his life insurance policy to the insurance company. The surrender value is the cash value of the contract less a surrender charge.

25. **If an owner elects to receive the surrender value of the life insurance policy, why might it be taxable?**
    When the owner elects to receive the surrender value of the life insurance policy, the policy benefit is not being paid out by reason of the death of the insured, and therefore does not qualify for the income tax exclusion (under IRC Section 101(a)). If the surrender value paid to the owner is greater than his adjusted basis in the policy, the difference between the amount received and the owner’s adjusted basis is considered taxable ordinary income.
26. **How do dividends from corporations differ from dividends on a life insurance policy?**  
When a corporation distributes a cash dividend to its shareholders, the dividend represents a distribution of the earnings and profits of the corporation, which is fully subject to income tax. A dividend on a life insurance policy is a return of the premiums paid to the policy owner which constitutes an overcharge by insurance company. The return of the overcharge is not taxable to the extent that the policy owner has an adjusted basis in the life insurance policy.

27. **List some of the advantages and disadvantages of taking a loan from a life insurance policy.**  
**Advantages:**  
- The interest rate may be lower than commercially available lending rates.  
- The loan does not have to be paid back.  

**Disadvantages:**  
- The outstanding loan balance, plus the accumulated interest, will reduce the death benefit on the policy dollar for dollar.  
- If the policy lapses, the gain in the policy will include the outstanding loan balance and will be subject to income tax.

28. **The designated beneficiary of a life insurance policy will receive the death benefit of the policy at the death of the insured. Why is the designation of the beneficiary not a completed gift for federal gift tax purposes?**  
The designation of the beneficiary of a life insurance policy is not a completed gift for federal gift tax purposes because the owner may still exercise all economic rights over the policy, including the ability to change the designated beneficiary again.

29. **In general, how is the value of a life insurance policy in pay status determined for federal gift tax purposes?**  
The value for federal gift tax purposes of a life insurance policy in pay status is the sum of the policy's interpolated terminal reserve plus any unearned premium as of the date of the gift.

30. **In general, how is the value of a paid-up life insurance policy determined for federal gift tax purposes?**  
The value for federal gift tax purposes of a paid-up life insurance policy is the replacement cost of the life insurance policy as of the date of the gift.

31. **How can the owner of a life insurance policy receive a current income tax deduction for the value of the life insurance policy?**  
Life insurance is generally considered ordinary income property. Thus, the gifting of life insurance policies to a charity will follow the charitable rules for ordinary income property. The deduction for donated ordinary income property is equal to the fair market value of the property reduced by any ordinary income that would have resulted from its sale - usually the adjusted basis of the property. In the event the fair market value is less than the adjusted basis (no ordinary income would result from this sale), the deduction is equal to the fair market value of the property itself. If the policy is “paid-up” (i.e., no premiums remain to be paid), the fair market value is equal to the policy's replacement value. If premiums remain unpaid on the policy, the fair market value is the policy's interpolated terminal reserve value. If the donor continues to pay the premiums on any policy donated to a charity, those premium payments are an additional tax deductible charitable gift.
32. If the owner of a life insurance policy gifts ownership of the policy to charity, what is the effect of the owner continuing to pay the premiums?
When the owner gifts ownership of the life insurance policy to a charity and continues making the premium payments, the owner will have an itemized deduction equal to the premium payment.

33. Define “incident of ownership” in a life insurance policy and give an example.
An incident of ownership in a life insurance policy is the ability to exercise any economic right in the policy. The right to borrow from the cash value of the policy, the right to assign the policy for a loan, and the right to change the beneficiary of the policy are all incidents of ownership in a life insurance policy.

34. With regards to the federal estate tax and life insurance, what is the three-year rule?
The three-year rule states that if an individual gratuitously transfers ownership of a life insurance policy on his or her life, or any incident of ownership in a policy on his or her life within three years of death, the death benefit of the policy is included in the individual's gross estate.

35. What provision allows the gift of premium payments to an ILIT to be eligible for the annual exclusion?
Including a Crummey provision in the trust document of an ILIT will make the gifts of premium payments to the trust eligible for the annual exclusion.
MULTIPLE-CHOICE PROBLEMS

1. Jack purchased a life insurance policy on his own life and never designated a beneficiary. In this case, the life insurance policy death benefit is:
   a. Included in Jack's federal gross estate if Jack dies within three years of the initial premium payment.
   b. Included in Jack's federal gross estate if Jack paid the premiums until his death.
   c. Never included in Jack's federal gross estate.
   d. Always included in Jack's federal gross estate.

   The correct answer is d.
   Because Jack did not list a beneficiary, the death benefit is payable to Jack's estate and will be distributed per Jack's will or the intestacy laws of Jack's state of residency. There is no three-year rule with regard to the initial premium payment of the life insurance policy as listed in option a.

2. Colleen transferred ownership of a whole life insurance policy on her life to an Irrevocable Life Insurance Trust (ILIT) six years ago and retained the right to borrow against the policy. When Colleen dies, the proceeds of the life insurance policy are:
   a. Included in Colleen's federal gross estate if she has any outstanding loans against the life insurance policy.
   b. Included in Colleen's federal gross estate if Colleen continued paying the policy premiums after the life insurance policy was transferred to the ILIT.
   c. Never included in Colleen's federal gross estate.
   d. Always included in Colleen's federal gross estate.

   The correct answer is d.
   The IRC (Section 2042) states that if a decedent owns a life insurance policy on her own life or possesses any incidents of ownership in the policy on the date of her death, the policy death benefit will be included in her gross estate. The right to borrow against the life insurance policy is considered an incident of ownership which would cause inclusion in Colleen's federal gross estate. Because Colleen retained this right, her federal gross estate would include the death benefit of the whole life insurance policy owned by the ILIT. Option a is incorrect because as long as the decedent has the right to take a loan against the policy, it is considered an incident of ownership. There is no requirement that a loan be outstanding. Option b is incorrect because paying the premium on a policy transferred to an ILIT does not create the incidents of ownership that would cause inclusion in Colleen's federal gross estate.
3. Carol and Joe, unrelated business partners, began operating a drug store in southern Florida. They funded a buy/sell agreement with a cross-purchase life insurance arrangement. Carol purchased a life insurance policy with Joe as the insured, and Joe purchased a life insurance policy with Carol as the insured. If Carol dies, which of the following is/are true?

1. The death benefit of the life insurance policy on Carol’s life, owned by Joe, is excluded from Carol’s federal gross estate.
2. The death benefit of the life insurance policy on Carol’s life, owned by Joe, is included in Carol’s federal gross estate if Carol owns 50% or more of the stock of the drug store.
3. The value of the life insurance policy on Joe’s life, owned by Carol, is included in Carol’s federal gross estate.
4. The death benefit of the life insurance policy on Carol’s life, owned by Joe, is included in Carol’s federal gross estate.

a. 1 only.
b. 1 and 3.
c. 1, 2, and 3.
d. 1, 2, 3, and 4.

The correct answer is b. Option 1 is correct because Carol’s federal gross estate will not include the death benefit of the life insurance policy on her life owned by Joe because Carol does not possess any incidents of ownership in the policy. Option 3 is correct because when an individual dies owning a life insurance policy on the life of another person, the value of the life insurance policy will be included in her federal gross estate. Option 2 is incorrect because Carol’s ownership in the drug store does not change the fact that Carol does not possess any incidents of ownership in the life insurance policy on her life, owned by Joe. The death benefit of a life insurance policy on Carol’s life would only be included in Carol’s federal gross estate if she possessed any incidents of ownership in the life insurance policy. Option 4 is incorrect because the death benefit of a life insurance policy is only payable at the death of the insured. In this case, Joe has not died, and as such, the death benefit of the policy is not payable to Carol and would not be included in Carol’s federal gross estate.

4. Many individuals who have been diagnosed with terminal illnesses sell their life insurance policies to viatical settlement providers. Which of the following statements is true regarding the transfer of a policy from an individual with a terminal illness to a viatical settlement provider?

a. If the individual dies within three years of the transfer, the full proceeds of the insurance policy are included in his federal gross estate.
b. The individual is subject to capital gain taxes on the difference between his adjusted basis in the life insurance policy and the amount paid to him by the viatical settlement provider.
c. Regardless of when the individual dies, the payment from the viatical settlement company is excluded from income tax.
d. If the individual lives for more than one year after the transfer, the individual will be subject to income tax on the payment from the viatical provider.
The correct answer is c.
The IRC (Section 101(g)) excludes amounts received under a life insurance contract on the life of an insured individual who is chronically or terminally ill from the individual's gross income. There is no requirement that the individual die within a certain period of time. Option a is incorrect because the three-year rule (Section 2035) only applies to gratuitous transfers of life insurance. In this case, the life insurance policy was sold to the viatical settlement provider, and thus would not be subject to the three-year rule.

5. Last year, Jerry gave a life insurance policy with a $400,000 death benefit to his son, Brad. At the time of the gift, the value of the life insurance policy was $50,000 and Jerry had to pay $5,000 in federal gift tax. Jerry unexpectedly died this year. What amount will be included in Jerry’s federal gross estate related to this life insurance policy?
   a. $5,000.
   b. $400,000.
   c. $405,000.
   d. $455,000.

The correct answer is c.
Life insurance proceeds on policies gratuitously transferred within three years of death are included in the gross estate of the donor. Gift tax paid within three years of death is included in the federal gross estate as well under the gross-up rule.

6. Four years ago, Marvin gave a life insurance policy with a $750,000 death benefit to his daughter, Marsha. At the time of the gift, the value of the life insurance policy was $65,000, and Marvin paid $10,000 in federal gift tax. Marvin unexpectedly died this year. What amount will be included in Marvin’s federal gross estate related to this life insurance policy?
   a. $0.
   b. $10,000.
   c. $65,000.
   d. $750,000.

The correct answer is a.
Because Martin died more than three years after the gratuitous transfer of the life insurance policy, Martin’s federal gross estate would not include any amount related to this life insurance policy.

7. Louie gave a $1,000,000 life insurance policy on his own life to his brother. At the date of the gift, the life insurance policy was valued at $200,000. Which of the following statements regarding the gift of this life insurance policy is correct?
   a. If Louie dies two years after this gift, his federal gross estate will include $200,000.
   b. If Louie dies four years after this gift, his federal gross estate will include $200,000.
   c. If Louie dies two years after this gift, his federal gross estate will include $1,000,000.
   d. If Louie dies four years after this gift, his federal gross estate will include $1,000,000.
The correct answer is c.
The three-year rule (IRC Section 2035) states that if an individual gratuitously transfers ownership of a life insurance policy on his life, or any incident of ownership in a policy on his life within three years of death, the death benefit of the policy is included in his federal gross estate. In this case, only answer c provides the correct solution. If Louie dies two years after the gift, the gratuitous transfer of the policy falls within the three-year rule and the death benefit is included in Louie’s federal gross estate. All of the other options are incorrect.

8. As part of his employee benefit package, Larry’s employer provided him with a $50,000 term life insurance policy. Larry named his wife, Cynthia, as the sole beneficiary of the life insurance policy. Which of the following statements is true with regard to this life insurance policy?

a. Because the term insurance policy is part of a group term life insurance policy, the death benefit payable to Cynthia is considered taxable income.
b. At Larry’s death, the death benefit payable to Cynthia will be included in Larry’s federal gross estate.
c. Larry cannot change the beneficiary of the life insurance policy without Cynthia’s prior written approval.
d. If Cynthia dies before Larry, her federal gross estate will include the life insurance policy death benefit.

The correct answer is b.
The death benefit of the life insurance policy will be included in Larry’s federal gross estate because Larry was the owner of the life insurance policy and had the right to change the designated beneficiary of the policy. Option a is incorrect because the death benefit payable from a policy issued under a group term life insurance policy is treated just like the death benefit payable from any other life insurance policy. As long as the policy has not been transferred for valuable consideration, the beneficiary will receive the death benefit without any income tax ramifications. Option c is incorrect because the owner of the policy can change the beneficiary designation without any authorization from the current beneficiary. Option d is incorrect because the beneficiary of a life insurance policy does not have any right to the death benefit until the insured has died. In this case, Cynthia, the beneficiary, has died before the insured on the policy, Larry, so Cynthia will not include any amount related to the life insurance policy in her federal gross estate.

9. James owned a life insurance policy with his brother, Fred, as the insured. When James died, his will specifically bequeathed the policy to his sister, Lolita. Which of the following statements regarding the value of the life insurance policy to include in James’ federal gross estate is not true?

a. If the life insurance policy is a term life insurance policy, the value is the unused premium.
b. Because Fred is still alive, the value of the policy included in the gross estate is zero.
c. If the life insurance policy is a whole life policy in pay status, the value is equal to the unearned premium plus the interpolated terminal reserve.
d. If the life insurance policy is a paid-up or single premium life insurance policy, its value is its replacement cost.

The correct answer is b.
This statement is completely false. There is no such exception. The policy, like all other assets owned by the decedent, will be included in the gross estate, (with very few exceptions). All of the other statements are true.
10. Which of the following is not a reason for using life insurance in an estate plan?
   
   a. The proceeds of the life insurance policy can be used to create liquidity for the decedent's estate.
   b. The proceeds of the life insurance policy can be used to eliminate any debt for the decedent's surviving spouse.
   c. The insured can borrow the death benefit from the life insurance policy to fund his retirement.
   d. Expected future education expenses can be funded with the death benefit of the life insurance policy.

   The correct answer is c. The insured can borrow against the cash surrender value of the life insurance policy to fund his retirement. The insured cannot borrow the death benefit of the life insurance policy. All other statements are reasons for using life insurance in an estate plan.

11. Which of the following statements regarding term life insurance is correct?
   
   a. The premium on a term life insurance policy reflects the actuarial risk that the insured will die during the term of the contract.
   b. The cash accumulation account of a term life insurance policy is invested in the bond portfolios of the insurer.
   c. The cash accumulation account of a term life insurance policy is invested in individual stocks selected by the insured.
   d. The premium of a term life insurance policy will decrease as the pure cost of life insurance increases.

   The correct answer is a. The premium on a term life insurance policy reflects the actuarial risk that the insured will die during the term of the contract. Options b and c are incorrect because a term life insurance policy does not have a cash accumulation account. Option d is incorrect because the premium of a term life insurance policy increases as the pure cost of life insurance increases.

12. Travis, 28, and his wife, 26, have recently moved into a new home. They financed $350,000 of the $500,000 purchase price and utilized all of their savings to pay the down payment of $150,000. Travis's wife stays at home with their 3-year old son, Alex, and is expecting a baby in two months. Which of the following statements is not correct?
   
   a. Travis should consider a 30 year term life insurance policy on his life which could fund his children's educational needs if he should die during the term.
   b. A universal life insurance policy would provide Travis with the insurance protection of a term life insurance policy and would also provide him with a tax-deferred savings mechanism.
   c. A whole life insurance policy would provide Travis with the least expensive temporary life insurance needed to eliminate the mortgage at his death.
   d. Travis should consider a whole life insurance policy on his life which could fund his children's educational needs or pay off the mortgage if he dies while those needs exist, and which could also provide Travis with a source of funds if he lives through his retirement.
The correct answer is c.
A whole life insurance policy is a permanent type of insurance - eliminating a mortgage is a temporary need. Also, whole life insurance at Travis’ age would have the highest premium. All of the other statements are correct.

13. Mary selected her son as the beneficiary of a whole life insurance policy on her life. Which of the following statements concerning this beneficiary designation is incorrect?

   a. Mary could have chosen her son and her daughter as co-beneficiaries.
   b. If Mary lists her nephew as the contingent beneficiary of the whole life insurance policy, her nephew will collect the death benefit if her son dies before Mary.
   c. If Mary entered an irrevocable beneficiary designation, she is the complete owner of the life insurance policy and can amend the irrevocable beneficiary designation at anytime.
   d. At Mary’s death, her son will receive the death benefit of the life insurance policy.

The correct answer is c.
If Mary had entered an irrevocable beneficiary designation, she continues to be the owner of the life insurance policy, but she will need her son’s permission to amend the beneficiary designation. All of the other statements are true.

14. Which of the following statements regarding universal life insurance policies is true?

   a. As long as the premium of a universal life insurance policy is paid, the insurer guarantees that the life insurance policy will remain in force.
   b. A universal life insurance policy will be cancelled if the pure cost of insurance protection increases and the cash accumulation account does not have the funds to pay the additional cost.
   c. Funds within the cash accumulation account of a universal life insurance policy cannot be used to pay the policy premium.
   d. A universal life insurance policy allows the insured to select the cash accumulation account investments.

The correct answer is b.
A universal life insurance policy is a term life insurance policy with a cash accumulation account attached to it. In the initial years of the policy, the premium paid is in excess of the pure cost of the insurance, and the excess is deposited into the cash accumulation account. In the later years of the life insurance policy, the pure cost of the insurance will increase, but the insured will continue to pay the same premium. Funds within the cash accumulation account will pay any difference between the pure cost of the insurance and the premium paid by the owner. However, if the cash accumulation account does not have the funds to pay the difference, the life insurance contract will lapse. Only a whole life insurance policy will remain in force when the pure cost of the insurance is in excess of the premium paid. Option a is incorrect because the universal life insurance policy will lapse if the policy premium is not paid and the cash accumulation account does not have the funds necessary to pay the policy premium. Even if the policy premium is paid, the universal life insurance policy will also lapse if the cash accumulation account does not have the funds to pay the excess pure insurance cost. Option c is incorrect because the cash accumulation account can be used to pay the policy premium. Option d is incorrect because the insured does not select the investments for the cash accumulation account.
15. Raphael is the owner of a variable life insurance policy on his life. His wife, Isabel is the designated beneficiary. Which of the following statements is correct?

a. If Isabel dies before Raphael, Isabel must include the value of the life insurance policy in her federal gross estate.

b. At Raphael's death, the variable life insurance policy death benefit will be paid to Isabel.

c. When the beneficiary of a life insurance policy is the wife of the insured/owner, the death benefit payable to the wife is included in the insured's probate estate.

d. As beneficiary, Isabel can borrow against the death benefit during Raphael's life.

The correct answer is b.

As listed beneficiary, Isabel will receive the death benefit of the life insurance policy at Raphael's death. Option a is incorrect because only the owner of a life insurance policy is required to include the value in her federal gross estate. In this problem, Isabel is only the beneficiary; she does not have any right to the life insurance policy until Raphael's death. Option c is incorrect. A life insurance policy is included in the insured’s probate estate only when the death benefit is payable to the insured or no designated beneficiary has been selected. Option d is incorrect because the beneficiary of a life insurance policy cannot borrow against the death benefit.

16. Jason is the owner of a paid-up whole life insurance policy on his own life. All of the following statements are correct except:

a. Jason has title to the whole life insurance contract.

b. Jason can borrow against the cash value of the whole life insurance policy.

c. The death benefit of the whole life insurance policy will be included in Jason’s federal gross estate.

d. If Jason gifts the whole life insurance policy to his son, the value for gift tax purposes is the sum of the policy’s interpolated terminal reserve plus any unearned premium.

The correct answer is d.

Because it is a paid-up whole life insurance policy, the value for gift tax purposes is the replacement cost of the policy. All of the other statements are true.

17. Jim purchased a yacht from Ronald for $200,000 seven years ago. The terms of the sale included a note of $50,000 and cash for the remaining amount. Ronald had a zero basis in the yacht. Immediately after purchasing the yacht, Jim’s business began to fail and Jim could no longer make the payments. In exchange for the note, Jim gave Ronald a life insurance policy on his life with a face value of $50,000. This year, Jim died and Ronald received the death benefit as the designated beneficiary of the policy. How much of this death benefit is taxable to Ronald?

a. $0.

b. $50,000.

c. $150,000.

d. $200,000.
18. In which of the following situations would the death benefit of a life insurance policy be taxable, partially or wholly?

   a. Deborah, as designated beneficiary, received the $80,000 death benefit of Larry’s life insurance policy. Larry had purchased the policy for $35,000 from his employer when he retired in 1997.

   b. Clean-it, LLC, received the $100,000 death benefit of David’s life insurance policy. In 1990, David, the owner of 50% of the stock of Clean-it, LLC sold the policy to Clean-it for $12,000 as part of an entity-type buy-sell agreement.

   c. Weakam, Ullo, and Evans, LLP, received the $1,000,000 death benefit of a life insurance policy on Randy Evans, one of the managing partners. Randy had sold the policy to Weakam, Ullo, and Evans, LLP in 1945 when the business was just starting out as part of an entity-type buy-sell agreement.

   d. Adam sold a $100,000 death benefit life insurance policy to Dawson for $35,000 as part of cross-purchase buy-sell agreement. Dawson and Adam were the only two shareholders of Cupper Corporation and each owned a policy on the other.

The correct answer is d.

If a life insurance policy is transferred for valuable consideration, the death benefit in excess of the transferee’s adjusted basis will be subject to income tax. An exception exists for any transfer of the life insurance policy for valuable consideration to the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is a shareholder or officer, or a transferee who takes the transferor’s basis in the contract. Option a is an example of a transfer to the insured. Option b is an example of a transfer to a corporation in which the insured is a shareholder. Option c is an example of a transfer to a partnership in which the insured is a partner. Option d does not fit any of the exceptions. The life insurance policy is transferred to Dawson, not Cupper Corporation.

19. Pamela’s dad, Tim, died on August 10 of this year. Six years ago, Tim had gifted ownership of a paid-up $1,000,000 whole life insurance policy on his life with a replacement value of $150,000 and an adjusted basis of $100,000 to Pamela. If Pamela, as designated beneficiary, receives the death benefit of the life insurance policy this year, how much will be taxable to her?

   a. $0.

   b. $50,000.

   c. $100,000.

   d. $1,000,000.

The correct answer is a.

A gift of a life insurance policy is not a transfer for valuable consideration and as such the death benefit, payable by reason of Tim’s death, is not included in Pamela’s taxable income.
20. Jerry is the owner, the insured, and the beneficiary of a whole life insurance policy. Which of the following situations regarding this scenario is incorrect?
   a. When Jerry dies, his federal gross estate will include the death benefit of the life insurance policy.
   b. When Jerry dies, his probate estate will include the death benefit of the life insurance policy.
   c. Jerry’s estate will include the death benefit in its taxable income.
   d. If Jerry designates a new beneficiary before he dies, and the beneficiary is alive at the time of Jerry’s death, the death benefit will be excluded from his probate estate.

   The correct answer is c.
   The IRC (Section 101(a)) provides an income tax exemption for a death benefit paid from a life insurance contract by reason of the death of the insured. In this case, Jerry’s estate will receive the death benefit, but it will still be excluded from the taxable income of the estate because of the exemption provided by the IRC (Section 101(a)). All of the other statements are correct.

21. Which of the following is not a valid settlement option for the designated beneficiary of a life insurance policy?
   a. A lump-sum payment of the death benefit.
   b. Individual Retirement Account Rollover.
   c. Life Annuity.
   d. Term Annuity.

   The correct answer is b.
   A beneficiary of a life insurance policy cannot rollover the death benefit into an IRA. The designated beneficiary of a life insurance policy can choose to receive the death benefit as a lump sum payment, as an annuity (term or life), or the beneficiary can leave the death benefit on deposit with the insurer. In some situations, the owner of the life insurance policy will establish an irrevocable settlement option, thereby choosing the beneficiaries settlement option.

22. Jackie’s father died last month and she is the listed beneficiary on his insurance policy. Jackie has contacted the insurer and has requested a lump-sum payment of the death benefit of the life insurance policy. Which of the following statements regarding this lump-sum payment is true?
   a. When Jackie receives the lump-sum payment of the death benefit from the insurer, part of the payment will be taxable.
   b. Because Jackie has elected a lump-sum payment of the death benefit, she will actually receive a payment less than the face value of the policy.
   c. Had Jackie elected the life annuity, each payment would have been excluded from her gross income.
   d. Jackie could have elected to leave the death benefit on deposit with the insurer and continue the tax-deferred growth of the policy.
The correct answer is a.
When Jackie receives the lump sum death benefit, she will also receive fully taxable interest on the death benefit that accrued from the time of her father's death to the date the insurer paid Jackie. Option b is a false statement. Option c is incorrect because if Jackie had elected the annuity option, a portion of each annuity payment would have been taxable as interest income and the remaining portion of the payment would have excluded from Jackie's taxable income. Option d is incorrect because if Jackie had chosen to leave the death benefit on deposit with the insurer, she would have to include the earnings on the death benefit in her taxable income each year.

23. Who has the right to surrender a life insurance policy for its cash surrender value?
   a. The insured of the life insurance policy.
   b. The owner of the life insurance policy.
   c. The beneficiary of the life insurance policy.
   d. The insurer of the life insurance policy.

The correct answer is b.
The owner of a life insurance policy is the only party to a life insurance policy who can surrender a life insurance policy for its cash surrender value.

24. At age 69, John, a widower, needs more than his pension and Social Security income to pay his living and medical expenses. His children do not have the resources to help him and he has already liquidated his individual retirement accounts. Which of the following is true if John decides to surrender his whole life insurance policy to the insurer?
   a. John would receive the present value (using the actuarial factors according to John's life expectancy) of the life insurance policy death benefit.
   b. Any amount of surrender value paid to John would reduce the death benefit payable to the listed beneficiary of the policy dollar-for-dollar.
   c. To surrender the life insurance policy, John must receive the approval of the listed beneficiary of the life insurance policy.
   d. The surrender value of the policy would be paid to John and the life insurance contract would be cancelled.

The correct answer is d.
If John surrenders the life insurance policy to the insured, the insurer will pay John the surrender value, the contract will be cancelled, and correspondingly there will not be a death benefit payment at John's death. Option a is incorrect because if John surrender the life insurance policy, the surrender value is equal to the cash accumulation account less a surrender charge from the insurer. Option b is incorrect because once the policy is surrendered the contract is cancelled and no death benefit would be paid to the beneficiary. Option c is incorrect because John would not have to receive the approval of the listed beneficiary unless it was stated that he had made an irrevocable beneficiary designation.
25. Gayle is the owner and insured on a $1,000,000 face value life insurance policy in pay status. Gayle's adjusted basis in the life insurance contract is $250,000. If Gayle gifts this life insurance policy to her daughter and listed beneficiary, Celeste, which of the following statements is correct?

a. After the date of the gift, any dividends paid on the life insurance policy will be taxable to Gayle.
b. Celeste can amend the beneficiary designation of the life insurance policy to include her son, Matt, as a co-beneficiary.
c. If Celeste dies before Gayle, Celeste's probate estate will include the replacement value of the life insurance policy.
d. If Gayle dies within 3 years of the gift of the life insurance policy to Celeste, the death benefit will be included in Gayle's probate estate.

The correct answer is b. After Gayle has gifted the life insurance policy to Celeste, Celeste can select the designated beneficiary of the life insurance policy. Celeste has the right to change the beneficiary selected by Gayle and does not need Gayle's approval to amend the designation. Option a is incorrect because any dividends issued on the life insurance policy will be paid to Celeste and the dividends are nontaxable distributions equal to return of capital. Option c is incorrect because the value of a life insurance policy in pay status is the sum of the interpolated terminal reserve plus any unearned premium. Option d is incorrect as the life insurance policy will be included in Gayle's federal gross estate if she dies within three years of the gift of the life insurance policy.

26. The owner of a life insurance policy has decided to surrender the life insurance policy to the insurer. Since inception of the life insurance contract, the owner has paid premiums of $100,000 and received cash policy dividends equal to $20,000. If at the surrender date, the owner receives a cash payment of $140,000 from the insurer, what is his gain/loss subject to income tax on the life insurance policy?

a. $0.
b. $20,000.
c. $40,000.
d. $60,000.

The correct answer is d. The owners adjusted basis in the property would be $80,000 - the sum of the premiums paid on the policy less any dividends received (a dividend on a life insurance policy is a return of the policy owner's adjusted basis). If the insurer pays a cash surrender value of $140,000, the gain on the policy would be $60,000 ($140,000-$80,000).
27. Mr. Fahey, age 71, has been paying the premium on a whole life insurance policy for the past 30 years. The policy has a $1,000,000 death benefit and has built up a cash value of $250,000. Mr. Fahey's adjusted basis in the life insurance policy is $200,000. Which of the following statements is not correct?

a. If the insurer pays Mr. Fahey a life insurance policy dividend of $3,000, his adjusted basis in the whole life insurance policy will increase to $203,000.

b. If the insurer pays Mr. Fahey a life insurance policy dividend of $4,000, his adjusted basis in the whole life insurance policy will decrease to $196,000.

c. The cash surrender value of Mr. Fahey's whole life insurance policy would be equal to the cash value of the policy less a life insurance policy surrender charge.

d. Mr. Fahey can take a loan from the cash value of the life insurance policy without suffering any income tax consequences.

The correct answer is a. Life insurance policy dividends are a return of the policy owner's adjusted basis. Any policy dividends received would decrease, not increase, the owner's adjusted basis. All other options are correct.

28. Which of the following statements is true?

a. Life insurance policy dividends are taxable as dividend income.

b. Life insurance policy dividends kept on deposit with the insurer will generate tax-deferred interest income.

c. If a life insurance policy lapses, any outstanding loans will be required to be repaid to the insurer immediately at the lapse.

d. If a life insurance policy owner takes a loan from the policy, the death benefit of the policy will be reduced by any outstanding loans plus the accumulated interest due on the loan at the death of the insured.

The correct answer is d. Option d is a correct statement. Option a is incorrect as policy dividends are return of the policy owner's adjusted basis. Option b is incorrect as life insurance policy dividends kept on deposit with the insurer will generate taxable interest income to the life insurance policy owner. Option c is incorrect because the outstanding loan would be offset by the surrender value.

29. Warren purchased a single premium life insurance policy on his life 15 years ago for $65,000. The current value of the policy is $155,000. Which of the following statements regarding Warren's life insurance policy is true?

a. If Warren takes a loan of $140,000 against the cash surrender value of the life insurance policy, he will have long-term capital gain of $65,000.

b. If Warren takes a loan of $65,000 against the cash surrender value of the life insurance policy, he will not have any capital gain.

c. If Warren takes a loan of $75,000 against the cash surrender value of the life insurance policy, he will recognize $10,000 of long-term capital gain.

d. If Warren takes a loan of $155,000 against the cash surrender value of the life insurance policy, he will recognize $90,000 of long-term capital gain.
The correct answer is d.
Because Warren's life insurance policy was funded with a single premium payment, the policy is considered a modified endowment contract (MEC). Any loan from a MEC is considered capital gain to the extent there is any gain in the contract. Therefore, option d is correct because Warren takes a $155,000 loan from the contract and has $90,000 ($155,000-$65,000) of capital gain. Warren must recognize capital gain to the extent of the capital gain inherent in the policy before receiving a return of capital. In answer a, if Warren borrowed $140,000, he would also recognize $90,000 of capital gain. In option b, Warren would recognize $65,000 of capital gain if he took a loan of $65,000. If Warren borrowed $75,000 as in option c, Warren would have a $75,000 capital gain.

30. Twelve years ago, Paul purchased a single premium $1,000,000 life insurance policy on his own life for $150,000 and named his daughter as the sole beneficiary. Paul gifted ownership of the policy to Holly this year when the value of the life insurance policy was $200,000. Paul paid $15,000 of gift tax on the transaction. At Paul's death, how much of the death benefit that Holly receives will be subject to income tax?

a. $0.
b. $785,000.
c. $800,000.
d. $1,000,000.

The correct answer is a.
Even though the life insurance policy is considered a modified endowment contract, the receipt of the death benefit remains income tax free to the extent the policy had not been transferred for valuable consideration. In this case, the transfer to Holly was a gift, not a transfer for valuable consideration, so the death benefit is not subject to income tax.

31. The owner of a whole life insurance policy would like to exchange his life insurance policy for an annuity on his life. Currently, the value of the life insurance policy is $150,000, excluding a $50,000 loan the owner has against the life insurance policy, and the owner's adjusted basis in the policy is $65,000. Which of the following statements is true?

a. If the owner exchanges the life insurance policy for an annuity, the owner must recognize a $135,000 capital gain on the exchange.
b. The owner's basis in the annuity after the exchange will be $115,000.
c. The exchange will be considered a transfer for valuable consideration.
d. If the annuity has a death benefit, the beneficiary will have to include the death benefit in her taxable income at the owner's death.
In an exchange of a life insurance policy for an annuity, the owner of the life insurance policy must recognize gain to the extent he receives boot in the exchange. Outstanding loans against the life insurance policy are considered boot. In this problem, the owner has potential gain of $135,000 ($150,000 + $50,000 - $65,000), and must recognize gain to the extent he had a loan outstanding, or $50,000. Normally, the owner's adjusted basis in the life insurance policy will be carried over to the annuity, but if the owner recognizes any gain on the exchange or pays additional expenses, he will increase his adjusted basis in the annuity by the gain recognized or the expenses paid. Because the owner had to recognize gain on the loan, he will increase his adjusted basis by this recognized gain of $50,000. After the exchange, the owner's adjusted basis in the annuity is $115,000, the adjusted basis in the life insurance policy increased by the amount of gain recognized on the transaction ($65,000 + $50,000). Option c is incorrect as an exchange is not considered a transfer for valuable consideration. Option d is incorrect because the death benefit would not be subject to income tax as long as the death benefit is payable by reason of the death of the owner.

32. Sally was recently diagnosed with stage four lung cancer. Her doctors have given her 9 months to live. She has many medical expenses and needs money. If Sally sells a whole life insurance policy, with a $1,000,000 face value and a $250,000 adjusted basis to a viatical settlement provider for $350,000, how much capital gain will Sally have to recognize for income tax purposes on the sale?
   a. $0.
   b. $250,000.
   c. $350,000.
   d. $1,000,000.

The correct answer is a.

The IRC (Section 101(g)) states that amounts received under a life insurance contract on the life of an insured individual who is chronically or terminally ill may be excluded from gross income. Because her doctors expect her to die within 9 months, Sally is considered terminally ill. A terminally ill individual is a person who has been certified by a licensed health care provider as having a condition or illness that can reasonably be expected to result in death within 24 months.

33. In an attempt to exclude the death benefit of a paid up $500,000 face value whole life insurance policy from his gross estate, Jerry gifted the policy to his daughter. Six months prior to the gift, Jerry had been diagnosed with a terminal illness and given a 12 month life expectancy by his doctor. What is the gift tax value of the gift of this policy?
   a. The replacement cost of the life insurance policy.
   b. The life insurance policy’s interpolated terminal reserve plus any unearned premium.
   c. $500,000 discounted for Jerry’s six month life expectancy.
   d. The cash surrender value of the life insurance policy.

The correct answer is c.

If a physician has determined that the insured has a physical condition that is terminal, the value of a life insurance policy for gift tax purposes will be the death benefit, discounted for the predicted life expectancy of the insured.
34. In an attempt to exclude the death benefit of a paid up $500,000 face value whole life insurance policy from his gross estate, Jerry gifted the policy to his daughter. Six months prior to the gift, Jerry had been diagnosed with a terminal illness and given a 12 month life expectancy by his doctor. Jerry died 4 years after the gift of the life insurance policy. What amount is included in his federal gross estate related to this whole life insurance policy?

   a. $0.
   b. $250,000.
   c. $500,000.
   d. $500,000 discounted for Jerry’s six month life expectancy.

The correct answer is a.

Jerry's federal gross estate would not include any value related to this life insurance policy because he is not the owner or beneficiary of the life insurance policy at his death, and the gift was made more than three years prior to his death. An individual's federal gross estate only includes the death benefit of a life insurance policy on the insured, if the individual is the owner, the beneficiary, or if there was a gratuitous transfer of the life insurance within three years of the individual's death.

35. Which of the following is not considered an incident of ownership?

   a. The right to change the beneficiary of a life insurance policy.
   b. The insured making cash gifts to the owners of the life insurance policy of the premium amount.
   c. The right to take loans against the cash value of the life insurance policy.
   d. A provision in an ILIT that directs the trust to pay the federal estate taxes of the insured.

The correct answer is b.

If the insured makes cash gifts to the owners of the life insurance policy equal to the premium amount it is not considered an incident of ownership. All of the other options would be considered an incident of ownership.