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Subject: **Administration's Budget Contains Old and New Proposals Regarding Insurance and Transfer Tax Issues**

Major References: [*General Explanations of the Administration's Fiscal Year 2012 Budget, Department of the Treasury \(February 2011\) \("Greenbook"\)*](#)

Prior AALU Washington Reports: 10-135; 10-119; 10-96; 10-15; 09-50; 09-46; 09-27; 08-9; 03-110; 03-67; 02-77; 01-16; 00-88; 00-16

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The Obama Administration has released its FY 2012 budget, and the Treasury's General Explanations thereof (commonly know as the "Greenbook"). Together, they reprise many of the initiatives in the last two year's (FY 2011 and FY 2010) budgets, with the significant difference of incorporating some of the changes to the tax laws - including portability - enacted in the December tax compromise known as "TRA 2010." (See our Bulletins Nos. 09-27, 09-50, 10-15 and 10-135.) Notably, the Budget does not incorporate the recommendations of the President's "National Commission on Fiscal Responsibility and Reform" on which we reported in our Bulletin No. 10-119, although it does underscore the need to reform the tax code as part of addressing the nation's fiscal challenges.

Key life insurance and transfer (estate and gift) tax provisions are again included in the Administration's FY 2012 Budget. In addition, the Administrations proposes a number of other changes affecting individuals, including - after the 2012

sunset of TRA 2010 - higher rates, reduced deductions, automatic enrollment in IRAs, and other provisions of interest to AALU members. None of the proposed changes appear to be retroactive.

The descriptions below are chiefly those of the Treasury, and not AALU. AALU—in conjunction with the broader life insurance industry—has and continues to strongly oppose many of the proposals set forth below--particularly those relating to the COLI interest deduction and life insurance dividends received deduction (DRD) provisions. Legislators have recognized the points we have made about the harm that could be done by such proposals to the 75 million American families, thousands of businesses and millions of employees that depend on life insurance products. In each of the past two years, a significant majority of the members of the House Ways and Means Committee have written to the Treasury Department, stressing their disappointment in and opposition to these proposals.

A. Life Insurance & Annuity Changes.

The proposed Budget includes four items that were included in last year's (FY 2011) Budget, but that were not enacted into law.

1. *Reporting Requirements for Sales of Existing Contracts and Changes to Transfer for Value Rules.* The proposal would require a person or entity, who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 (the minimum in last year's budget was \$1 million) to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller. The concern is that, although recent years have witnessed growth in the number and size of life settlement transactions, compliance in reporting gain or loss from those transactions is sometimes hampered by a lack of information reporting. (For the Revenue Service's current position on the tax treatment of dispositions of life insurance policies in life settlement-type transactions, *see generally* Rev. Ruls. 2009-13 and 2009-14, discussed in our Bulletin No. 09-46.)

The proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to "buyers of policies." Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee. This is similar (but not identical) to the reporting requirements proposed to be applicable to the policy buyer (see above).

The reporting requirements and the changes to the transfer for value rule would apply to sales or assignment of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2011.

2. *Changes to Dividends Received Deduction for Life Insurance Company Separate Accounts.* Corporate taxpayers, including life insurance companies, generally qualify for a dividends-received deduction (DRD) with regard to dividends received from other domestic corporations, in order to prevent or limit taxable inclusion of the same income by more than one corporation. In the case of a life insurance company, however, the DRD is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income is sometimes referred to as "proration."

The policyholders' share equals 100 percent less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that are set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

The Treasury is concerned that the proration methodology currently used by some taxpayers may produce a company's share that greatly exceeds the company's economic interest in the net investment income earned by its separate account assets, which, in turn, generates controversy between life insurance companies and the IRS.

Therefore, the Treasury proposes that, as under current law, required interest would equal an earnings rate times the mean of reserves. For a separate account, the earnings rate would equal a gross earnings rate (net investment income of the account, divided by the mean of the account's assets), minus a company-retained percentage (amounts retained by the company from the account's net investment income, if any, divided by the mean of reserves). For this purpose, amounts retained by the company would be treated as funded proportionately by items included in net investment income and items not so included. Under the proposal, the company's share with regard to a separate account would approximate the ratio of the mean of the surplus attributable to the account to the mean of the account's assets. The company's share with regard to a company's general account would be computed as under current law.

The proposal would be effective for taxable years beginning after December 31, 2011.

AALU, in conjunction with the broader life insurance industry, has pointed out that many families, especially among the farming and small business communities, turn to annuities, variable annuities, and variable life insurance products as a means to protect their retirement security. As noted above, while DRD is available to all companies to avoid double taxation, under current law there are already unique proration rules which diminish DRDs for life insurance companies. Changing long-established rules for the DRD will result in additional costs due to higher taxes being passed on to policyholders depressing the value of their retirement security products.

3. *Expansion of Interest Expense Disallowance for COLI Policies.* Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business (defined to include a 20-percent owner of the business, as well as a limited number of the business' officers or employees). This interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula, except with respect to contracts that cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax preferred income, including earnings credited under life insurance, endowment and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

Because of concerns that highly leveraged businesses can find ways to circumvent these rules, the proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20-percent owners of a business that is the owner or beneficiary of the contracts. The proposal would be effective for contracts entered into after the date of enactment.

As AALU and the broader life insurance industry has pointed out, Congress reviewed the use and tax treatment of COLI extensively between 2003 and 2006. The result was a bi-partisan codification of COLI Best Practices in the Pension Protection Act of 2006 which reaffirmed that COLI is a good tool for American businesses and that the tax treatment of COLI is appropriate so long as businesses comply with the provisions in the law.

As noted above, the tax theory posited by the Treasury Department is that businesses are somehow evading rules that preclude businesses from deducting interest on loans associated with life insurance. However, under current rules, such interest is generally not deductible if the business borrows directly from a policy, pledges the policy as collateral, or if there is any demonstrable connection between the decision to purchase life insurance and the decision to borrow and deduct interest. The Treasury Department proposal would change the rules without any indication or information suggesting that businesses are evading current rules. In fact, the Treasury proposal would disallow interest to the extent a business owns life insurance even where it is very clear that the borrowing has no relationship to the life insurance. For example, if a life insurance policy was taken out today by a corporation to fund employee benefits and 15 years from now the corporation took out a loan to build a new business facility, the pro-rata interest disallowance proposal would still impose a tax penalty due to the unrelated life insurance holdings.

Further, despite vague concerns expressed by the Treasury about the fungibility of money, there is every indication that businesses are taking out life insurance in direct proportion to their need to fund and secure employee benefits. For example, COLI is used widely by banks and other financial institutions under guidance from their regulators and COLI is especially important during the financial crisis. In interagency rules set forth in OCC Bulletin 2004-56, the OCC, FDIC, Federal Reserve, and the OTS specifically provided that national banks and federal savings associations “may not purchase life insurance...for speculation or ...to generate funds for normal operating expenses other than employee compensation and benefits.” It also makes clear that such institutions “may not hold life insurance in excess of their risk of loss or cost to be covered.” Other businesses do not have any incentive to place more in life insurance than they need for protection and financing of employee benefits because every dollar they place in life insurance is not available to invest in business operations.

4. *Require Information Reporting for Private Separate Accounts of Life Insurance Companies.* Investments in assets through a separate account of a life insurance company generally give rise to tax-free or tax-deferred income, so long as the policyholder does not have so much control over the investments in the separate account that the policyholder, rather than the insurance company, is treated as the owner of those investments.

The Treasury has determined that, in some cases, private separate accounts are being used to avoid tax that would be due if the assets were held directly. Therefore, the Greenbook proposal would require life insurance companies to report to the IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year and represents at least 10 percent of the value of the account, the policyholder’s taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more private separate accounts.

A fifth proposal that was included in last year’s budget to permit partial annuitization of nonqualified annuity contracts was enacted into law as part of the 2010 Small Business Jobs Act. See our Bulletin No. 10-96.

B. *Estate and Gift Tax Changes.*

The estate and gift tax changes enacted in TRA 2010 (including (i) increased exemptions and (ii) reunification of estate, gift, and generation-skipping transfer taxes -- the proposal strongly championed by AALU -- which, as you know, AALU favors as a permanent rather than temporary, i.e., 2 year, feature of the Revenue Code) are, for the most part, presumed to sunset, in conformity with the current statute, at the end of 2012. In their place, under the proposed Budget, will be a permanent extension of “freeze 2009” - i.e., the parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of \$3.5 million -- another proposal strongly championed by AALU). One significant exception is the proposal to permanently extend “portability” of the exemption amount of the first spouse to die (the “deceased spouse’s unused exclusion amount” - or “DSUEA”). The Budget also proposes to “federalize” the rule against perpetuities by reducing the GST exemption of most trusts to zero after 90 years.

The EGT proposals may be summarized as follows:

1. ***Make Permanent the Portability of Unused Exemption Between Spouses.*** As explained in our Bulletin No. 10-135, current law, as the result of TRA 2010, now provides that the surviving spouse of a person who dies after December 31, 2010 and before January 1, 3013, may be eligible to increase the surviving spouse’s exclusion amount by the portion of the predeceased spouse’s exclusion that remained unused at the predeceased spouse’s death. The surviving spouse may use the unused exclusion of such predeceased spouse only if the executor of that predeceased spouse makes an election on a timely filed estate tax return.

The Greenbook notes that:

“[w]ithout this portability provision, spouses are often required to retitle assets into each spouse’s separate name and create complex trusts in order to allow the first spouse to die to take full advantage of his or her exclusion. Depending upon the nature of the couple’s assets, such a division may not be possible. Such a division also has significant consequences under property law and often is not consistent with the way in which the married couple would prefer to handle their financial affairs. Portability would obviate the need for such burdensome planning.”

The Budget therefore would extend portability permanently, thus making the use of the last predeceased spouse’s unused exemption available to all estates of decedents dying and gifts made after December 31, 2012.

2. ***Consistency in Value for Transfer and Income Tax Purposes.*** The basis of property acquired from a decedent generally is the fair market value of the property on decedent’s date of death. In contrast, a donee’s basis in property received by gift during the life of the donor generally is the donor’s adjusted basis in the property, increased by gift tax paid on the transfer (or, if lower, its fair market value on the date of the gift). While the recipient of a distribution of income from a trust or estate must report on the recipient’s own income tax return the exact information included on the Schedule K-1 of the trust’s or estate’s income tax return, this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

Effective as if the date of enactment, the proposal would require both consistency -- for estate, gift and income tax purposes -- and a reporting requirement. The basis of property received by reason of death would have to equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor’s basis determined as set forth above. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). In the absence of an applicable exception, a reporting requirement would be imposed on the executor of the decedent’s estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS.

3. Modifications to Valuation Discounts. Section 2704(b) (enacted as part of Chapter 14 of the Internal Revenue Code) provides that, where a partnership or corporate interest is transferred to (or for the benefit of) a member of the transferor's family and, immediately before the transfer, the transferor and his family hold control of the entity, any "applicable restrictions" (including restrictions on the ability to liquidate the entity) are disregarded when valuing the transferred interest. Such restrictions are not disregarded, however, and will be given effect, if they are not more restrictive than state law provisions that would govern in the absence of provisions in the entity documents.

The proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. The proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

4. Minimum Terms for GRATs. Section 2702 (also a part of Chapter 14) provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a "qualified interest" - *i.e.*, a fixed annuity or unitrust interest, as defined in applicable Treasury regulations. A grantor retained annuity trust - or GRAT - is one such qualified interest, and current law prescribes no particular minimum or maximum length of term for a GRAT.

GRATs, as noted in the proposal, have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. Taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to 2 years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years (a number that appears to have been chosen because it is the same as the 10-year minimum term of so-called "*Clifford*" trusts that were created on or before March 1, 1986). Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk of the grantor's death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. This loss would presumably be the Treasury's gain.

This proposal - a perennial revenue offset - would apply to trusts created after the date of enactment.

5. ***Limit Duration Of Generation-- Skipping Transfer (GST) Tax Exemption.*** As we have written about periodically (*see, e.g.*, our Bulletins Nos. 10-81 and 08-33) there have from time to time been proposals -- carefully monitored by AALU -- to impose a two-generation or other temporal limit on the duration of trusts to which GST tax exemption has been allocated, after which they would be subject to taxation.

When the GST tax was first enacted, the law of most (generally, all but about three) states included the common law Rule against Perpetuities (RAP) or some statutory enactment or version of it that would result in a self-imposed limit on the duration of trusts. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust. The amount of the GST tax exemption that could be allocated to a trust was also much lower.

However, many states have now either repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with \$1 million and a maximum duration limited by the RAP, to trusts funded with \$5 million and continuing (and growing) in perpetuity. The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

The Budget proposal would provide that, with few exceptions, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

This proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

C. **Other Changes.**

There are numerous other proposed changes affecting individuals and corporations. The Treasury fact sheet accompanying the Greenbook, summarizes (and we emphasize that this is the Treasury's summarization and not AALU's) the "key administration priorities" as follows:

- **Investments in Innovation, Infrastructure, and Education: Provides Targeted Incentives for:**
 - Innovation: Tax Incentives for Clean Energy, Research & Development, and Small Business Investment
 - Infrastructure: Expanding the Successful Build America Bonds Program and Making it Permanent
 - Education: A Permanent American Opportunity Tax Credit to Provide \$10,000 for Four Years of College
- **Middle-Class Tax Relief: Provides Needed Relief for Middle-Class Families by:**
 - Increasing the Tax Credit for Child and Dependent Care Expenses by up to 75 Percent

- Permanently Expanding the Earned Income Tax Credit for Larger Families and Married Couples
- Automatic IRAs and Tax Credits for Employers that Help Workers Save for Retirement
- **A Responsible and Credible Plan to Address Budget Deficits: Reduces the Deficit by \$1 Trillion and Makes Room for Other Priorities by:**
 - Allowing the 2001 and 2003 Tax Cuts to Expire after 2012 for Households Making More Than \$250,000 Per Year
 - Reforming Tax Expenditures for High Income Taxpayers
 - Imposing a Financial Crisis Responsibility Fee to Recoup TARP Losses and Reduce Financial Risk
 - Closing Tax Loopholes and Ineffective Tax Rules
- **A Simpler, More Fair, More Efficient Tax System: Improves the Tax Code by Proposing:**
 - Eleven Measures to Simplify the Tax Code to Make Tax Compliance Easier
 - More than a Dozen Proposals to Close the Tax Gap and Make the Tax System More Fair
 - Improvements to Tax Administration for Added Efficiency

Among the provisions affecting higher income taxpayers are the following;

- Reinstating the 39.6% income tax rate for incomes over \$373,650.
- Reinstating the 36% rate for married taxpayers with taxable incomes of more than \$250,000 and single filers with taxable incomes of more than \$200,000.
- Limiting to 28% the tax rate at which upper-income taxpayers can take itemized deductions. This approach, which would affect such itemized deductions as home mortgage interest and charitable contributions, has elicited a substantial objection from many commentators who point out the potential deleterious effect on charitable giving.
- Increasing the highest marginal tax rate for upper-income taxpayers for capital gains and dividends from 15% to 20%.
- Increasing taxes on certain executives of private-equity firms, venture-capital firms, some hedge funds and other partnerships by increasing the marginal tax rate on a “carried interest” in the firms’ profits from 15% to 39.6% (i.e., re-characterize from capital gain to ordinary income).

D. Retirement Plan Changes.

Automatic IRAs. Employers in business for at least two years that have more than ten employees would be required to offer an automatic IRA option to employees, under which regular contributions would

be made to an IRA on a payroll-deduction basis. If the employer sponsored a qualified retirement plan, SEP, or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. Employees could opt out if they choose.

Simplification. In the name of tax simplifications, the Administration proposes two changes that could significantly simplify the administration of retirement plans for many individuals and plan sponsor. The first would exempt an individual from the tax code's required minimum distributions (RMD) if the aggregate value of a person's individual retirement account and tax-favored individual retirement plan account does not exceed \$50,000 on the date it is measured for distribution purposes.

A second proposed change would permit 60 day rollovers of inherited assets from defined contribution plans or IRAs by nonspouse beneficiaries who now can roll over such accounts only from trustee to trustee.

The Greenbook also contains miscellaneous tax cuts for middle-income families and small businesses, such as the elimination of capital gains taxes on investments in certain small business stock.

It is still too soon to assume that any of the foregoing proposals will be enacted in their current form (or - given last two year's experience - at all). We will continue to monitor the progress of the Administration's proposals as they move through the legislative process.

Any AALU member who wishes to obtain a copy of the Treasury's Description of the Administration's FY 2012 Budget may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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