
MARKET TREND: The Patient Protection and Affordable Care Act, Pub. L. 111-148 (“ACA”), as upheld by the U.S. Supreme Court, contains several new tax provisions, including some that will effectively increase individual tax rates and require certain clients to consider tax planning prior to 2013. When combined with the scheduled year-end expiration of the Bush tax cuts, the projected income tax increases could be significant and will encourage a shift towards income tax-favored planning arrangements, such as annuities and life insurance, including private placement products, and deferred compensation plans.

SYNOPSIS: The constitutionality of the ACA (specifically, the individual mandate and the Medicaid expansion provisions) was challenged as an invalid exercise of congressional powers. The Supreme Court largely upheld the constitutionality of the ACA, concluding that (1) the individual mandate was a valid exercise of Congress’ taxing powers (but not a valid exercise of its authority to regulate interstate commerce under the Commerce Clause or the Necessary and Proper Clause) and (2) the ACA’s expansion of Medicaid to nearly all Americans under age 65 with incomes of up to 133% of the federal poverty level was constitutional (but the penalty imposed on states that fail to expand coverage was not). The Supreme Court’s decision left the other provisions of the ACA intact, including a number of tax and tax-like provisions covering a wide spectrum of persons and entities.

TAKE AWAYS: The validity of the ACA under Congress’ taxing power highlights the need to pay close attention to the tax law changes that have been and will be implemented to support health care expansion. Some of these provisions have already taken effect and will continue under the Supreme Court’s ruling, while others will take effect as early as next year. Substantial tax provisions will affect individuals with income above the $200,000 to $250,000 thresholds beginning in 2013, potentially including higher individual tax rates, as summarized below.

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<tbody>
<tr>
<td>Long Term Capital Gain</td>
<td>15%</td>
<td>20%</td>
<td>3.8%</td>
<td>1.2%</td>
<td>25%</td>
<td>66.7%</td>
</tr>
<tr>
<td>Qualified Dividends</td>
<td>15%</td>
<td>39.6%</td>
<td>3.8%</td>
<td>1.2%</td>
<td>44.6%</td>
<td>197.3%</td>
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<tr>
<td>Interest, Rents, Royalties, etc.</td>
<td>35%</td>
<td>39.6%</td>
<td>3.8%</td>
<td>1.2%</td>
<td>44.6%</td>
<td>27.4%</td>
</tr>
<tr>
<td>Wages (Incl.)</td>
<td>36.45%</td>
<td>41.05%</td>
<td>0.9%</td>
<td>1.2%</td>
<td>43.15%</td>
<td>18.38%</td>
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Income acceleration or staggering and tax deferral arrangements should be considered to keep these individuals below the income thresholds for future years, if possible, to avoid tax increases. Thus, persons advising clients on investments, compensation, and tax deferral arrangements, such as annuities, life insurance, and qualified and non-qualified plans, must be familiar with these changes. Tax planning for individuals near the income thresholds is necessary before year-end.

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On June 28, 2012, the U.S. Supreme Court (the “Court”) largely upheld the constitutionality of the ACA, including the controversial individual mandate. The individual mandate requires non-exempt Americans to maintain a minimum level of health benefits or pay a penalty to the federal government. At issue before the Court was the question of whether the individual mandate was a valid exercise of Congress’ authority under the Commerce Clause, Necessary and Proper Clause or the Taxing Clause of the Constitution. The majority opinion, written by Chief Justice Roberts, concluded that the mandate was a valid exercise of Congress’ taxing powers, but was not a valid exercise of congressional authority under the Commerce Clause or the Necessary and Proper Clause.

The Court also upheld the ACA’s expansion of Medicaid to include nearly all Americans under age 65 with incomes of up to 133% of the federal poverty level but found unconstitutional the penalty authorized by the ACA on states that fail to expand coverage. As enacted, the ACA provided that the federal government could terminate all Medicaid funding to states that failed to implement the Medicaid expansion provisions. The Court found that Congress’ spending power under the Constitution can encourage the behavior of states but cannot compel behavior. In the Court’s opinion, the large penalty for failing to expand Medicaid would compel behavior and was therefore invalid.

The Court’s decision upholding the ACA’s individual mandate and Medicaid expansion provisions leaves the other provisions of the ACA intact. As we reported in Bulletin No. 10-40, the ACA, along with the Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, contain a number of tax and tax-like provisions (summarized below) that cover a wide spectrum of persons and entities. These provisions can now be implemented following the Court’s decision.

Individual Taxes

- **New Medicare Tax on Investment Income**

  The ACA created a new tax on investment income for individuals, estates, and trusts to pay for Medicare beginning in 2013 (“Medicare Tax”). Net investment income means interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net capital gain from the disposition of property (other than property held in a trade or business). Investment income is reduced by allowable deductions. The tax applies to individuals and to estate and trusts as follows:

  Individuals: The tax is 3.8% of the lesser of an individual’s (i) net investment income or (ii) modified adjusted gross income (“MAGI”) that exceeds $200,000 for individuals, $250,000 for joint return and surviving spouse filers, and $125,000 for married taxpayers filing separately.
Ex. 1: Simple Computation

A married couple’s MAGI is $400,000 for 2013, and they have $100,000 of net investment income. In this case, the Medicare Tax is imposed on the net investment income as follows: $3,800.

If, however, the couple has $200,000 of net investment income, the Medicare Tax is imposed on the excess of the couple’s MAGI over the applicable threshold, as follows: $5,700.

Ex. 2: Application to Capital Gains

Since the MAGI of the couple in Ex. 1 is above the threshold, any sale of a capital asset will result in the imposition of the Medicare Tax. If the couple sells stock held as a capital asset during 2013 for a gain of $100,000 (and this is their only net investment income), the Medicare Tax will be: $3,800.

In addition, however, the capital gain will be taxed at 20% (if the current 15% maximum tax rate is not extended). This tax rate will effectively increase in 2013 by another 1.2% as a result of the return of the phase-out of itemized deductions for high-income earners, resulting in an additional tax liability of $1,200. As a result, the couple will have a total tax liability of $25,000 (25%) from a sale in 2013, as opposed to $15,000 (15%) if they sell in 2012.

Ex. 3: Application to Qualified Dividends and Interest

Assume that instead of capital gains of $100,000, the couple in Ex. 1 receives a qualified dividend of $100,000 in 2013, which is the couple’s only net investment income. Again, the Medicare Tax will be $3,800.

In addition, however, the highest marginal income tax rate applicable to qualified dividends will reach 40.8%, assuming (i) the qualified dividend income rules are not extended (which currently tax qualified dividends at capital gain rates), (ii) the top marginal ordinary rates increase to 39.6%, and (iii) the phase-out of itemized deductions for high income earners returns in 2013. As a result, in 2013, the $100,000 dividend will be taxed as ordinary income, and the couple will pay up to $44,600 in total taxes ($40,800 in federal income tax plus $3,800 of Medicare Tax (an effective rate of 44.6%)), as opposed to $15,000 in total tax if the dividend is distributed in 2012.

The same amount of tax would be due if this couple received $100,000 of interest income, although, notably, the ACA excludes interest on tax-exempt bonds from the definition of net investment income.

Estates and Trusts: The tax is 3.8% of the lesser of an estate’s or trust’s (i) undistributed net investment income or (ii) adjusted gross income (“AGI”) over the amount at which the highest estate and trust tax bracket begins ($388,350 for trusts and estates in 2012).

- New Hospital Insurance Tax on High-Income Taxpayers

Beginning in 2013, high-income taxpayers ($250,000 for a joint return or a surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all other filers) will be subject to a 0.9% increase in the employee portion of the hospital insurance tax part of FICA on wages.
in excess of the threshold (“High Income Tax”). This tax is added to the existing 1.45% hospital insurance tax on earnings below these thresholds, meaning the payroll tax imposed on high wage employees will increase from 1.45% to 2.35% on income over the threshold amounts. In the case of a joint return, the additional tax is on the combined wages of the employee and the employee’s spouse. There is no cap for the High Income Tax. Thus, the combined 2.35% rate will be significant for high wage earners, a group that will only grow over time since the threshold amounts will not be indexed for inflation.

Ex. 5: Computation of the High Income Tax

Assume that the couple in Ex. 1 does not have any net investment income and their $400,000 of MAGI is solely from wages. The couple will not be subject to the Medicare Tax but will pay $3,625 (1.45% x 250,000) on their income below the threshold and another $3,525 (2.35% x 150,000) on the income above the threshold, for a total High Income Tax of $7,150.

- Increased AGI Threshold for Itemized Deduction of Unreimbursed Medical Expenses

The threshold for itemized deductions for unreimbursed medical expenses will increase from 7.5% to 10% of the taxpayer’s AGI beginning in 2013. For taxpayers over age 65, however, the threshold remains at 7.5%.

- New Excise Tax on Uninsured Individuals

The ACA added the individual mandate to the Internal Revenue Code (the “Code”) as new Section 5000A. Under this Code Section, certain U.S. citizens and legal residents are required to maintain a minimum level of health insurance or be subject to an excise tax. While the requirement applies to all individuals who file taxes, some limited exceptions apply to those individuals who are incarcerated, not present in the United States, or who maintain religious exemptions. The penalty for individuals who fail to meet the minimum coverage requirement generally is the greater of (1) the applicable percentage of a taxpayer’s household income in excess of the income threshold for filling an income tax return under Code Section 6012(a)(1) or (2) the applicable flat dollar penalty amount, each as specified below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of Household Income in Excess of Threshold Filing Amount</th>
<th>Flat Dollar Penalty (Indexed for Inflation after 2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>1%</td>
<td>$95</td>
</tr>
<tr>
<td>2015</td>
<td>2%</td>
<td>$325</td>
</tr>
<tr>
<td>2016</td>
<td>2.5%</td>
<td>$695</td>
</tr>
</tbody>
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The flat dollar penalty will not be assessed on persons below a certain income level or if the cost of the health insurance coverage would exceed 8% of a person’s household income.

- Increased Tax on Nonqualifying Health Savings Account and Archer Medical Savings Account Distributions

The tax on distributions made after December 31, 2010 from health savings accounts or Archer medical savings accounts increases to 20% if the distributions are not used for qualified medical expenses.
• **New Limit on Health Flexible Spending Account Contributions**

Starting in 2013, contributions to health flexible spending accounts under cafeteria plans will be limited to $2,500 per year. The dollar amount will be inflation indexed after 2013.

• **New Premium Assistance Credit for Individuals Purchasing Through State Benefit Exchanges**

Some individuals and families who do not have coverage through their employer or Medicaid may be eligible for a refundable tax credit to subsidize the cost of health insurance premiums. These credits may be used to purchase health insurance coverage through a state or federally established exchange established by the ACA. The tax credit is first available in 2014 and equal to the excess of the taxpayer’s premiums over a threshold range of 2% of income for those at up to 133% of the federal poverty level, depending on the family size involved, to 9.5% of income for those at four times the federal poverty level, depending on the family size involved. The amounts are subject to inflation adjustment after 2014.

• **Modified Definition of “Dependent” for Exclusion of Amounts Received Under Health Insurance Plan**

The ACA changed the definition of “dependent” for the purposes of Code Sections 105(b), 162(l)(1), 401(h), and 501(c)(9) effective for plan years beginning on or after September 23, 2010. The taxpayer may now deduct expenses for the medical care of a child through the end of the calendar year in which the child attains age 26.

**Employer Taxes**

• **Creation of Small Business and Non-Profit Tax Credit**

As part of the Code Section 38 business tax credit, the legislation provides for an additional amount to cover the premium cost of health insurance coverage beginning in 2010. Certain small businesses (those with 25 or fewer full-time employees with an average annual wage of less than $50,000) may be eligible for a credit of up to 50% of employer contributions for insurance premiums. The tax credit is gradually phased out for businesses with average wages between $25,000 and $50,000 and for business with between 10 and 25 full-time employees. Small businesses with 10 or fewer employees and an average annual wage of less than $25,000 would be eligible to get the maximum credit. Non-profits may be eligible for a 35% credit of employer contributions against payroll taxes, other than income taxes.

• **Creation of SIMPLE Cafeteria Plans for Small Businesses**

As of 2011, small businesses that employ fewer than 100 employees on average may now set up SIMPLE cafeteria plans. Small business employers may be eligible for a safe harbor from the nondiscrimination requirements for cafeteria plans and the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including benefits under a self insured medical expense reimbursement plan, benefits under a dependent care assistance program, and group term life insurance. To qualify, the cafeteria plan must satisfy minimum eligibility and participation requirements, as well as minimum contribution requirements. The safe harbor requires employer contributions to non-highly compensated employees of at least 2% of compensation (whether or not
the employee elected to participate), or a 100% employer matching contribution capped at 6% of the employee’s compensation.

- **Requirement that Employers Disclose on Form W-2 the Value of the Employee’s Health Insurance Coverage Sponsored by the Employer**

Under the ACA, employers must disclose on Form W-2 the aggregate value of the health insurance coverage that the employer provides to the employee for tax years beginning after December 31, 2010. This excludes contributions to flexible spending arrangements. The IRS made this disclosure requirement optional for 2011 and does not require disclosure by small employers who issue fewer than 250 Form W-2s until further guidance is issued.

- **Penalty on Employers Lacking Coverage**

The ACA imposes a penalty on large employers that do not offer affordable coverage to their full-time employees. The coverage offered must cover 60% of the allowable costs under the plan. The term “large employers” is defined as having more than 50 full-time employees.

If a large employer does not offer its full-time employees the opportunity to enroll in an employer-sponsor plan that provides at least minimum essential coverage, the employer may be subject to a penalty. If any full-time employee receives a tax credit via an exchange, the employer is then subject to an excise tax calculated as the number of full-time employees (excluding the first 30 employees) during the month multiplied by $166.67 or $2,000 per year.

Also, in any month that a large employer offers its full-time employees the opportunity to enroll in an employer-sponsored plan that provides at least minimum essential coverage but the coverage is unaffordable, and a full-time employee receives a tax credit via a state exchange for which a premium tax credit or cost-sharing reduction is allowed or paid to the employer, that employer may be subject to the excise tax.

- **New Excise Tax on High-Cost Employer Plans**

High-cost employer plans are subject to the new Code Section 4980I for tax years beginning after December 31, 2017, which imposes an excise tax on the cost of health insurance that exceeds a set amount ($10,200 for individuals and $27,500 for families). The excise tax is 40% of the cost in excess of the threshold amount multiplied by a “health cost adjustment percentage” and adjusted for the “age and gender excess premium amount” (as these terms are defined in the legislation). The ACA imposes an annual limitation of $10,200 for self-only coverage and $27,500 for all other coverage for the year 2018, subject to inflation adjustment thereafter. Exceptions apply for certain professionals.

- **New Reporting Requirements**

New Code Section 6055 requires insurers (including employers who self-insure) that provide minimum coverage to any individual during a calendar year to report the health insurance coverage to both the individual and the IRS for periods beginning after 2014. The report would include detailed information, such as the name, address, and taxpayer identification number of the insured, as well as the dates of coverage. A final rule on this provision is expected in the coming months.

**Other Provisions**

- **New Requirements on Non-profit Hospitals**
Non-profit hospitals are now subject to Section 9700 of the ACA, which imposes a new “community benefit” standard under Code Section 501(c)(3) on non-profit hospitals. The hospitals must now report on community needs, implement a financial assistance program and limit charges for indigent patients, and restrict their fundraising activities. The IRS issued a notice of proposed rulemaking regarding additional requirements for charitable hospitals on June 26, 2012.

- **New Fees on Health Plans**

The legislation created new Code Section 4376, which imposes a fee on self-insured health plans for plan years beginning on or after January 1, 2013. The employer must pay a fee equal to $2 ($1 for the plan year ending during 2013) for each specified health plan multiplied by the average number of lives the plan covers. The legislation also created new Code Section 4375, which imposes the same fee on the issuer of a policy ($1 for the policy year ending during 2013). The fee amount changes for policies issued after September 30, 2014.

**Interaction with the Potential Expiration of President Bush’s Tax Cuts**

Along with the implementation of the various taxes and penalties under the ACA, there is a long list of tax breaks that may or may not be extended past 2012. As noted, beginning in 2013, itemized deductions again will be phased out under Code Section 68 by the lesser of 3% of AGI and 80% of the amount of itemized deductions. In addition, absent an extension, (1) the top rate on long-term capital gains (currently 15%) will increase to 20% and (2) qualified dividends, which are currently taxed at long-term capital gains rates, will be taxed as ordinary income (at a potential effective rate of up to 44.6%, if the current maximum tax rate of 35% is not extended). The combination of the new Medicare and High Income Taxes with these higher income tax rates will have a significant impact on many U.S. taxpayers, as summarized in the chart at the beginning of this report.

While there is a possibility that the current rate structure will be extended, at least in part, into or perhaps through 2013, clients and their advisors must currently plan with the understanding that the future of the Bush tax cuts cannot be predicted with any certainty at this time.

**Next Steps**

With the Court’s decision on the ACA, the impending tax law changes will create opportunities for persons advising clients with regard to investments, compensation, and tax deferral arrangements. Specifically, the new limitations on medical expense deductions and flexible spending account income exclusions, coupled with higher tax rates on income and investment returns, will require a financial review before year-end for individuals near the triggering income thresholds.

Clients whose marginal rates are expected to be at the top brackets (and with income that will exceed the threshold MAGI for both the Medicare and High Income Taxes) will be most affected and would be advised to prepare. There are planning techniques available to these clients that can mitigate the imposition of both the higher effective rates and the new ACA taxes, such as accelerating capital gains and other compensation into 2012, staggering payments from retirement plans after 2012 to minimize the portion of a client’s MAGI that exceeds the Medicare Tax threshold, and minimizing excess “wages” after 2012 that would be subject to the High Income Tax. Some specific techniques clients may wish to consider include the following:

- **Life Insurance and Deferred Compensation Planning**
In a potentially rising income tax rate environment, the income tax-deferred investment growth within an annuity or a life insurance policy, coupled, in the case of life insurance, with the income tax-free payment of death benefits, will generally increase the attractiveness of these products.\(^6\) Clients also may show more interest in high cash value policies rather than guaranteed death benefit products, given their significant investment component.

Private placement annuities and life insurance may particularly appeal to those clients with substantial exposure to tax-inefficient investments, such as hedge funds, commodity funds, or high-yield taxable bonds. These clients may see returns consistently taxed at the highest income tax rates but not receive distributions to offset their tax liability. Holding similar investments through the investment account of a properly structured private placement product defers the gain recognition and also avoids the potential for phantom income.

Additionally, higher income taxes likely will drive an increase in deferred compensation planning for senior executives and high wage earners, with corresponding opportunities for life insurance funding.

- **Recognition of Capital Gains in 2012**

To the extent that a client is holding an appreciated capital asset with significant built-in gain, the client may desire to assess whether to engage in transactions to trigger the built-in gain before December 31, 2012. In addition to traditional investment type capital assets, this includes (i) owners of closely-held equity interests in an entity that has a built-in gain, and (ii) home owners with a built-in gain above the exemption threshold that are considering selling and moving to a different home.

In addition, clients with an open naked short position with a built-in long term capital gain (*i.e.*, because the price of the underlying asset has dropped) should assess whether to close the short position at a gain this year. Furthermore, if a client holds a position in a derivative (*i.e.*, forwards, options, futures or notional principal contracts) in which the underlying asset is capital, and the client currently has a built-in gain in the position, to the extent the contract allows for an early termination (and not so many derivative contracts allow for an early termination), the client is advised to consider actual or constructive terminations of such positions before December 31, 2012. Leveraged employee stock ownership plans (“ESOPs”) also provide opportunities to accelerate dividends. In conclusion, taxpayers should consider dispositions of any positions with a built-in capital gain that can be disposed this year.\(^7\)

- **Acceleration of Qualified Dividends Paid by Closely Held Business**

To the extent that individual shareholders of closely held corporations are able to control payments of dividends during 2012, and assuming the corporation has sufficient earnings and profits to pay a dividend, it is advised for such shareholders to consider causing the corporation to pay the dividend before December 31, 2012, because the effective rate on dividends may almost triple in 2013.

To effect a dividend payment in 2012, the closely held corporation may also redeem shares of stock held by the owner in a transaction that is treated as a dividend. A stock redemption is taxed as a dividend if the proportionate ownership of the shareholder is not reduced. Leveraged recapitalizations, which enable the entity to make qualified dividend distributions this year; leveraged ESOPs and note dividends also provide opportunities to accelerate dividends.
• **Special Treatment for Extraordinary Dividends**

Code Section 1059 imposes special basis adjustment rules on investments in stock held by corporations. This rule has been extended to qualified dividend income. Under the extraordinary dividend rule applicable to individuals, if “extraordinary dividends” are received with respect to such stock, any gain or loss on the sale or exchange of the related shares will, to the extent of such dividends, be treated as long-term capital loss (rather than short-term). Extraordinary dividends for this purpose are generally defined as dividends in excess of ten percent of the holder’s adjusted basis in common stock (five percent on preferred stock), subject to special aggregation rules included in Code Section 1059(c).

Generally, all dividends paid during an 85-day period (based on ex-dividend dates) must be aggregated in making the determination of whether the dividend is extraordinary. However, if dividends paid during a one-year period exceed 20% of a shareholder’s basis, then all of the dividends paid during such period must be aggregated and the applicable percentage for determining whether all such dividends are extraordinary is twenty percent rather than ten percent.

The application of the extraordinary dividend rules to qualified dividend income is a non-event if the shares have already been held for more than one year. Careful planning will be required, however, if the shares have not been held for this length of time.

**Notes**

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1. In accordance with Code Section 68, itemized deductions must be reduced by a specified percentage of the amount by which adjusted gross income exceeds a specified threshold. This reduction does not apply for tax year 2012 but, unless such a relief is extended, will return in 2013. The reduction in 2013 will equal the lesser of (i) 3% of that excess adjusted gross income over the threshold or (ii) 80% of the itemized deductions (e.g., charitable contributions).

2. Currently, an individual's “qualified dividend” income is taxed at the same rates that apply to net capital gains, subject to several limitations and restrictions. The dividend must be payable by either a U.S. corporation or a foreign corporation from certain listed treaty jurisdictions. For common stock, the shareholder must hold the stock for at least 61 days unhedged, which holding period should begin 60 days before the ex-dividend date (the first date following the declaration of a dividend on which the purchaser of a stock is not entitled to receive the next dividend payment). The holding period must be longer for preferred stock paying dividends attributable to periods of more than 366 days.

3. Wages are as defined in Code Section 3121(a).

4. Currently, employers and employees each pay a payroll tax of 1.45% (for a total of 2.9%) to finance Medicare hospital insurance. This rate will continue to apply to taxpayers whose income does not meet the threshold.

5. The additional High Income Tax will be withheld by the employer in the same way as other payroll taxes are withheld. Married employees will have to make the determination as to their combined wages with their spouses.

6. Additionally, there are many potential income and transfer tax benefits of holding life insurance through a properly structured irrevocable life insurance trust.

7. Note that the taxpayer can immediately repurchase the asset because the “wash sale” rules do not apply to gains, only to losses.


9. The shareholder may elect to use the share’s fair market value as of the day before the applicable ex-dividend date instead of the adjusted basis for determining whether the threshold is met. Fair market value is based on the closing price of the stock the day before the ex-dividend date.
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