Life Insurance Tax Traps:
Transfer for Value Rule and
Entity-Owned Policies

(excerpted from
Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications)

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by Steven B. Gorin*

I. Introduction

This document is excerpted from, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," a PDF in excess of 2,800 pages that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must have a physical mailing address, even though delivery is electronic. Please also add ThompsonCoburnNews@tcinstitute.com to your "trusted" list so that your spam blocker will not block it. Send any inquiries to the author at sgorin@thompsoncoburn.com and not

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All references to the "Code" are to the Internal Revenue Code of 1986, as amended. All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.

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You might also check out the author's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

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II.Q.4. Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity

II.Q.4.a. Funding the Buy-Sell

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger than the insured.[4035] If a business owner has a parent with an estate tax

[4035] If the policy proceeds are $250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a skip person receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. Reg. § 26.2662-1(c)(2)(vi) explains:

> *Example (1)*. *Insurance proceeds less than $250,000*. On August 1, 1997, T, the insured under an insurance policy, died. The proceeds ($200,000) were includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GC is a transfer from a trust for purposes of chapter 13. Therefore, the payment of the proceeds to GC is a direct skip. Since the proceeds from the policy ($200,000) are less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.
>
> *Example (2)*. *Aggregate insurance proceeds of $250,000 or more*. Assume the same facts as in Example 1, except T is the insured under two insurance policies issued by the same insurance company. The proceeds ($150,000) from each policy are includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC1, was named the sole beneficiary of Policy 1, and T's other grandchild, GC2, was named the sole beneficiary of Policy 2. GC1 and GC2 are skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
>
> *Example (3)*. *Insurance proceeds of $250,000 or more held by insurance company*. On August 1, 1997, T, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of $750 to GC, T's grandchild, for life with the remainder payable to T's great grandchild, GGC. The face value of the policy is $300,000. Since the proceeds continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
>
> *Example (4)*. *Insurance proceeds less than $250,000 held by insurance company*. Assume the same facts as in Example 3, except the policy provides that the insurance company shall make monthly payments of $500 to GC and that the face value of the policy is $200,000. The transfer is

problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.[4036]

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,[4037] which have a stringent disability provision,[4038] and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller[4039] (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.[4040] Also note that split-dollar life insurance arrangements[4041] are subject to Code § 409A rules restricting the events upon which deferred compensation can be

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a transfer to a trust for purposes of chapter 13. However, since the total value of the policy ($200,000) is less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.

Example (5). On August 1, 1997, A, the insured under a life insurance policy, dies. The insurance proceeds on A's life that are payable under policies issued by Company X are in the aggregate amount of $200,000 and are includible in A's gross estate. Because the proceeds are includible in A's gross estate, the generation-skipping transfer that occurs upon A's death, if any, will be a direct skip rather than a taxable distribution or a taxable termination. Accordingly, because the aggregate amount of insurance proceeds with respect to Company X is less than $250,000, Company X may pay the proceeds without regard to whether the beneficiary is a skip person in relation to the decedent-transferor.

[4036] This tool, generational split-dollar, is described as it was approved in fns. 4271-4273 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4037] See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4038] See part III.B.7.c.vi Deferred Compensation, especially fn. 7052.

[4039] For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7th Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

[4040] See part II.Q.4.i Life Insurance LLC.

[4041] Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.i.ii.(b) Corporate Ownership of Policy, including *Machacek v. Commissioner*, where the Sixth Circuit, reversing the Tax Court and ignoring the parties' briefs, held that Reg. § 1.301-1(q) caused economic benefits under even compensatory split-dollar agreements to be treated as distributions and not compensation income to an employee-shareholder.

paid, the violation of which trigger significant tax, penalties, and interest.[4042] When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.[4043] Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance,[4044] so that they do not constitute an incident of ownership.[4045]

If a shareholder is uninsurable, a sinking fund may be used to accumulate funds for premium payments or at least to provide a down payment. The remainder of the purchase price can be subject to an installment agreement whereby the payments can be spread out over a long time period.

When using life insurance, make sure the beneficiary is the owner. Otherwise, when the insured dies, the owner is deemed to have transferred the death benefit to the beneficiary.[4046]

[4042] Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

[4043] In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value; see fn. 4061 for more information on this authority.

[4044] See part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[4045] Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the insured is disabled for a prescribed period of time, the insured declines to participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255. The ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion; see fn 7162 in part III.B.9 Code § 2038.

[4046] *Goodman v. Commissioner of Internal Revenue*, 156 F.2d 218 (2nd Cir. 1946).

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the owner and beneficiary of the policy,[4047] and the insurance proceeds received by the corporation will not be subject to income tax.[4048] Unless a valid agreement that satisfies Code § 2703[4049] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,[4050] but perhaps offset by the buy-sell obligation.[4051]

Insurance premiums used to fund the agreement are not deductible by the corporation.[4052] Same with "any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual."[4053] This rule disallowing interest does "not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000."[4054] In this context, "key person" means an officer or 20% owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer cannot exceed the greater of (A) five individuals, or (B) the lesser of 5% of the total officers and employees of the taxpayer or 20 individuals.[4055] In this context, a "20% owner" means any person who owns directly 20% or more of the outstanding stock of a corporation, stock possessing 20% or more of the total combined voting power of all stock of a corporation, or 20% or more of the capital or profits interest in a partnership.[4056] For purposes of determining stock ownership and applying the $50,000 debt limit, all members of a controlled group are treated as one taxpayer,

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[4047] Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6). If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includible in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.

[4048] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. See part II.Q.7.a.v Redemptions and Alternative Minimum Tax.

[4049] See part II.Q.4.h Establishing Estate Tax Values.

[4050] Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933).

[4051] In the *Blount* case, cited in footnote 4316, the Tax Court included the life insurance in the business' value, but the 11th Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.

[4052] Code § 264(a)(1).

[4053] Code § 264(a)(4). However, such interest reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

[4054] Code § 264(e)(1). However, Code § 264(e)(2) may limit the interest deduction to a particular rate.

[4055] Code § 264(e)(3).

[4056] Code § 264(e)(4).

and this limitation shall be allocated among the members of such group in such manner as the Treasury/IRS may prescribe.[4057]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[4058] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[4059] However, tax deferral on installment sales can be limited,[4060] so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax. Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value. *Matthies v. Commissioner*, 134 T.C. 141 (2010 regarding tax years 2000 and 2001), rejected the taxpayer's attempt to used interpolated terminal reserve for income tax purposes, although the rejection appears to have responded to the taxpayer's failure to prove value when engaging in what many people call a pension rescue plan that the court considered to be a scheme. The case also held that, if and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. Rev. Proc. 2005-25 applies generally in the context of valuing compensation under Code §§ 79, 83 and 402. Except for split-dollar arrangements and except for employee trusts and annuity plans subject to Code §§ 402(b) and 403(c), Reg. § 1.83-3(e) provides:

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

For qualified retirement plan purposes, see Reg. § 1.402(a)-1(a)(2), the preamble to which is T.D. 9223, which does a good job of explaining how that rule changed. Reg. § 1.402(a)-1(a)(2) requires that surrender charges be ignored in calculating the amount of a distribution from a qualified retirement plan. However, for a nonexempt employee trust (a trust established to fund payments of compensation to be made in the future), surrender charges are considered. *Schwab v. Commissioner*, 136 T.C. 120 (2011) (when surrender charges exceeded cash value, policies valued based on prepaid death benefit when no other evidence of value was introduced), *aff'd* 715 F.3d 1169 (9th Cir. 2013), and *Lowe v. Commissioner*, T.C. Memo. 2011-106. *Lowe* summarized the holding of the Schwab Tax Court opinion, contrasting the qualified retirement plan concept of entire cash value against the nonexempt employee trust concept of entire value:

[4057] Code § 264(e)(5)(A). Code § 264(e)(5)(B), "Controlled group," provides:

> For purposes of this paragraph, all persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as members of a controlled group.

[4058] However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

[4059] Code § 453.

[4060] Code § 453A.

> We concluded that while the entire cash value of a life insurance policy is determined without regard to surrender charges, the entire value of a life insurance policy is determined by its fair market value, which may include surrender charges. We thus rejected the simple proposition that surrender charges should never count or that they should always count, instead reading section 402(b) to require a court to consider the payment of surrender charges as part of a more general inquiry into the policy's fair market value.

Lowe pointed out that the Tax Court denied the IRS' motion for reconsideration of *Schwab*. In denying the IRS' motion for summary judgment, the *Lowe* court held:

> The facts of the instant case are virtually identical to those presented in *Schwab*. The policies were variable universal life insurance policies with steep premiums, and both were distributed from nonexempt employee trusts in late 2003. Both policies carried surrender charges that rendered the accumulated value of the policy zero or less than zero. In Schwab we decided that the fair market values of the policies the taxpayers received were less than their accumulated values. Here, we are unable to determine the fair market value of Mr. Lowe's policy because the record does not allow us to do so.

Thus, the Tax Court appears to heavily weigh surrender charges in determining the value of a policy for income tax purposes, if a specific rule does not apply to override that. Specific rules to the contrary include qualified retirement plans (discussed above) and split-dollar arrangements (Reg. § 1.61-22(d)(4)(i)). Reg. § 1.83-3(e) provides further:

However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in § 1.61-22(b)) entered into (as defined in § 1.61-22(j)) on or before September 17, 2003, and which is not materially modified (as defined in § 1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to taxation of the cost of life insurance protection.

For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.[4061]

[4061] Reg. § 25.2512-6(a) provides:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

Reg. § 20.2031-8(a)(1), (2) provide:

> (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.[4062]

Using split-dollar arrangements[4063] to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-

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contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a retirement income policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1) is treated like a contract for the payment of an annuity for purposes of this section.

(2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximate by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

Rev. Rul. 78-137 held:

> In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.
>
> In order for an insurance policy to qualify as a comparable contract within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.
>
> Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a comparable contract within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case, the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a comparable contract that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a comparable contract is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

¶ 3.02[2][a][iii] of Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), provides an interesting discussion. Also see Anoia, Mendelsohn, and Slane, Complexities of Life Insurance Policy Valuation, *Estate Planning Journal* (June 2014), especially for some insightful analysis of valuing no-lapse guarantee policies.

[4062] See part II.Q.4.i, Life Insurance LLC.

[4063] See part II.Q.4.f Split-Dollar Arrangements.

dollar regulations,[4064] but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.[4065] If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

II.Q.4.b. Transfer for Value Rule; Basis

II.Q.4.b.i. Transfer for Value Rule Generally

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rule states that, if consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[4066] Specifically:[4067]

> A transfer for valuable consideration means any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value.

Under prior regulations,[4068] the IRS had taken the position that, when an insured transfers a policy on his life to his business co-owner, and his co-owner does the same, the transfer for value rules apply, and the death proceeds will be exempt only to the extent of the new premiums paid after the transfer, with the balance of the proceeds being taxed as ordinary income;[4069] given that

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[4064] Reg. § 1.61-22(c).

[4065] To avoid estate tax inclusion under Code § 2042.

[4066] Code § 101(a)(2) provides, subject to certain exceptions:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

Code § 101(a)(1) is the general rule that death benefits are not taxable.

[4067] Reg. § 1.101-1(f)(5).

[4068] Before T.D. 9879 (10/31/2019) was issued, Reg. § 1.101-1(b)(4) provided:

> … a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

[4069] Letter Ruling 7734048, reasoning:

> In the case of *Monroe v. Patterson*, 197 F.Supp. 146 (N.D. Ala. 1961), two policies were purchased on the life of an officer-stockholder, one by the insured and the other by the corporation. Subsequently insured entered into an agreement with two key employees for the purchase of his stock at his death. The policies were transferred to a trustee for use in partially financing the agreement and the key employees took over the payment of premiums. Upon insured's death, the proceeds were applied to the purchase of his stock. The Court held, the employees were transferees for value even though they had paid no purchase price for the policies. Their agreement to make the premium payments and to purchase the stock constituted a valuable consideration. Consequently the employees were taxed on the difference between the premiums they had paid and the proceeds applied toward their purchase of the insured's stock.

T.D. 9879 (10/31/2019) changed the regulation to require "cash or other consideration reducible to a money value," that position should no longer apply. A policy without cash value is subject to these rules.[4070]

Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4071] – as a transfer for valuable consideration. Also, Reg. § 1.101-1(g)(10), Example 10 assumes that a transfer to a corporation is a transfer for value.

The transfer for value rule does not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,[4072] a partnership in which the insured is a partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.[4073] This exception looks at the deemed owner of a grantor trust.[4074] A

For additional discussion of the transfer for value rules, see Zaritsky & Leimberg, ¶2.07. The Transfer-For-Value Rule Causing the Loss of Tax-Free Status, *Tax Planning With Life Insurance: Analysis With Forms* (WG&L).

[4070] *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

[4071] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4072] Not surprisingly, Letter Ruling 200120007 treated an LLC as a partnership in applying this rule. That LLC was formed to hold stock in a C corporation. The ruling also treated as having no adverse transfer-for-value effects:

- The transfer of a second-to-die policy to a trust deemed owned by one of the insureds.
- The transfer of a policy from a trust deemed owned by husband to a trust deemed owned by wife (due to Code § 1041 make it a substituted basis transaction).

Letter Ruling 9347016 applied this exception when shareholders bought a policy from a corporation (to facilitate a future cross-purchase of that corporation), triggering the transfer-for-value rule, but the investment partnership the shareholders owned triggered the exception. Same with Letter Ruling 9045004, which had the following facts:

> Corp. X, a C corporation, sells musical instruments. The stock of Corp. X is owned by A (42.85%), B (7.15%), C (42.85%), and D (7.15%). A, B, C, and D also are partners in Partnership. Partnership is involved in rental real estate activities and oil and gas production. A and C each have a 49% interest and B and D each have a 1% interest in Partnership. Corp. X is the owner and beneficiary of two life insurance policies on each of the lives of A and C. Premiums for the policies are paid for by Corp. X.
>
> Corp. X proposes to transfer the ownership and change the beneficiaries on the policies it owns as follows. The two policies currently insuring A will be transferred to B with B as the primary beneficiary and C and D as secondary beneficiaries.
>
> The two policies currently insuring C will be transferred to D with D as the primary beneficiary and A and B as secondary beneficiaries. It is represented that the secondary beneficiaries would be the beneficiaries should the primary beneficiary predecease the insured. It is further represented that Corp. X will retain the cash value portion of the policies and will continue to pay the premiums for that portion representing the cash value. The new owners of the policies will pay the premiums representing the life insurance portion of the policies.
>
> It is represented that the purpose of the transaction is to facilitate a buy-sell agreement. Upon the death of one or more of the insureds of the insurance policies, the financial means will be available for the remaining shareholders to secure control of Corp. X by purchasing the decedent's share from his estate.

[4073] Code § 101(a)(2)(A), (B).

[4074] Rev. Rul. 2007-13 posited the following situations:

> <u>Situation 1</u>. TR1 and TR2 are grantor trusts, both of which are treated as wholly owned by G under subpart E of Part I of subchapter J of the Internal Revenue Code. TR2 owns a life insurance contract upon the life of G. TR2 transfers the life insurance contract to TR1 in exchange for cash.

gift subject to a policy loan that is not in excess of basis is a substituted basis transaction that does not trigger the transfer-for-value rule.[4075] A transfer of an interest in a partnership that owns

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Situation 2. The facts are the same as in Situation 1, except that TR2 is not a grantor trust.

It held:

> The grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of applying the transfer for value limitations of § 101(a)(2). Accordingly, in Situation 1, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for a valuable consideration within the meaning of § 101(a)(2); in Situation 2, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is therefore excepted from the transfer for value limitations under § 101(a)(2).

Note that Rev. Proc. 2019-3, Section 3.01(14) states that the IRS will not issue letter rulings on:

> Section 101.—Certain Death Benefits.—Whether there has been a transfer for value for purposes of § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

However, that did not stop the IRS from issuing Letter Ruling 201423009, which including the following facts and conclusions:

> Individual A and his spouse, Individual B, are the grantors of the AC Trust. The AC Trust, as amended, is represented to be a grantor trust for federal income tax purposes owned by Individual A and Individual B. The AC Trust, as amended, owns and is currently the beneficiary of Number Y life insurance contracts on the joint lives of Individual A and Individual B and the Number X policy on Individual B (collectively, the life insurance contracts which total Number Z policies).
>
> The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the purported consideration both before and after the transaction. The second aspect of the transaction is that Individual B's interest in the AC Trust (in which she is a grantor) is being moved to the AB Trust in which Individual B's husband, Individual A, is the grantor. This action has the result, under § 1041(a), as being treated as a gift to her husband, Individual A, who pursuant to § 1041(b) receives a carryover basis in the life insurance contracts from his wife, Individual B.

[4075] Rev. Rul. 69-187 involved the following facts:

> *A* was the owner of a life insurance policy on his life under which his estate was designated as the beneficiary. The policy was in the face amount of 2,000x dollars, and had a value of approximately 860x dollars. Approximately 845x dollars had been advanced to *A* as a policy loan, on the security of the value of the policy and without personal liability on the part of *A*.
>
> *A* transferred the policy, subject to the indebtedness, to his wife, *B*. The transfer was made by the execution by *A* of a form that designated the new owner as *B*, and on her death, then to the executors, administrators, or assigns of *B*. *B* did not assume any personal liability with respect to the indebtedness.

Rev. Rul. 69-187 held:

> In the instant case the transferee's interest in the life insurance policy was acquired in part for a valuable consideration and in part by gift. Thus, upon the insured's death the insurance proceeds will be received under a policy that has a basis with respect to the transferee determinable in part

a life insurance policy is not subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.[4076] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[4077] is a substituted basis transaction that is not subject to the original transfer for value rules[4078] but may need to be checked under the reportable policy sale rule under part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

II.Q.4.b.ii. The Impact of Reportable Policy Sale on Transfer for Value Rule

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[4079] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[4080] Special rules for a reportable policy sale include:

- The exceptions to the transfer for value rule described above, all of which are Code § 101(a)(2)(A) or (B), do not apply.[4081] Thus, the death benefit generally is taxable, to the extent described in fn 4066.

- Various reporting requirements apply when the death benefit is paid.[4082]

The relevant committee report provides:

> **In general**
>
> The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision

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> by reference to the basis of the policy in the hands of the transferor. Accordingly, the limitation provided in section 101(a)(2) of the Code is not applicable. Upon the death of the insured, the proceeds of the policy are paid to *B* solely by reason of the death of the insured and are excludable from her gross income, as provided in section 101(a)(1) of the Code, except to the extent that section 101(d) of the Code is applicable by reason of payment of the proceeds at a date later than the death of the insured.

See also Letter Rulings 8628007 and 8951056, the latter pointing out that the transaction was substituted basis because basis exceeded debt.

[4076] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

> Sections 101, 761, and 7701.—Definitions. — Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consists or will consist of life insurance policies on the lives of the members.

[4077] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4078] Letter Ruling 201308019.

[4079] Code § 101(a)(3)(B).

[4080] Code § 101(a)(3)(B).

[4081] Code § 101(a)(3)(A).

[4082] Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

Reporting requirements for acquisitions of life insurance contracts

Reporting upon acquisition of life insurance contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale…

> **Scope of transfer for value rules**
>
> The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

The last paragraph above, consistent with the statutory language, does not say that a reportable policy sale is an additional type of transfer that is subject to the transfer for value rule; rather, it says that the exceptions to the transfer for value rule do not apply when the transfer is also a reportable policy sale. Notwithstanding this lack of income tax effect of a reportable policy sale that is not a transfer for value, a reportable policy may be subject to additional reporting obligations, which are purely informational.[4083]

II.Q.4.b.ii.(a). Income Tax Effect of a Reportable Policy Sale

Below is a discussion of Reg. § 1.101-1, overhauled by REG-103083-18.

Part 6 of the preamble to the proposed regulations, REG-103083-18 (3/25/2019), "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death," explains:

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from federal income tax under section 101(a)(1). However, if a life insurance contract is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount paid by reason of the death of the insured. Section 101(a)(2) provides that the excludable amount following a transfer for valuable consideration generally may not exceed the sum of (1) The actual value of the consideration paid by the transferee to acquire the life insurance contract and (2) the premiums and other amounts subsequently paid by the transferee. Section 101(a)(2) provides two exceptions to this transfer for value rule. Specifically, the limitation set forth in section 101(a)(2) does not apply if (1) The transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.
>
> Section 13522 of the Act added section 101(a)(3) to the Code. Section 101(a)(3)(A) provides that these two exceptions shall not apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale. Section 101(a)(3)(B) defines the term "reportable policy sale" to mean the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term "indirectly" applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

[4083] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn 4128.

> The proposed regulations update § 1.101-1(a)(1) of the existing regulations to reflect the repeal of section 101(b) (treatment of employees' death benefits) in 1996, and the addition of section 7702 (definition of life insurance contract) in 1984, section 101(j) (treatment of certain employer-owned life insurance contracts) in 2006, and section 101(a)(3) (exception to valuable consideration rules for reportable policy sales) in 2017. The proposed regulations remove the second and third sentences of § 1.101-1(a)(1) of the existing regulations and add a sentence at the end of § 1.101-1(a)(1) to address the earlier changes in law. To address the changes in law made by the Act, the proposed regulations under section 101 provide updated rules for determining the amount of death benefits excluded from gross income following a transfer for value or gratuitous transfer, including a reportable policy sale, and provide definitions applicable under section 101. The proposed regulations under section 6050Y adopt the relevant definitions by cross-reference.

Part 6 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(a) of the Proposed Regulations," explains:

> The proposed regulations would remove the second sentence of § 1.101-1(a)(1) of the existing regulations, which states: "Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision." As noted in the preamble to the proposed regulations, this update reflects the addition of section 7702 to the Code in 1984. See 84 FR 11015.
>
> One commenter stated that it is important that no changes be made with respect to the second sentence because the benefits described therein were written into older policies, some of which are still in effect, and changing the rules would negatively impact policyholders who have long relied on the appropriate exclusion of these death benefits from income. The commenter further stated that there is a longstanding and extensive body of court decisions and IRS rulings that establish the conditions under which such benefits qualify for treatment as life insurance proceeds.
>
> In response to these comments, the final regulations revise, rather than remove, the second sentence of § 1.101-1(a)(1) of the existing regulations to clarify that the sentence only applies to contracts issued on or before December 31, 1984, the effective date of section 7702.

Reg. § 1.101-1(a)(1) was changed by "Revising the second sentence of paragraph (a)(1), removing the third sentence of paragraph (a)(1), and adding a sentence at the end of paragraph (a)(1), as follows:

> … Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision.… If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).

Thus, Reg. § 1.101-1(a) now reads:

(1) *In general*. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and § 1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§ 1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).[4084]

(2) *Cross references*. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee -

  (i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72(m)(3) and paragraph (c) of § 1.72-16;

  (ii) Under annuity contracts to which § 1.403(b)-3 applies, see § 1.403(b)-7. For the definition of a life insurance company, see section 801; or

  (iii) Under eligible State deferred compensation plans described in section 457(b), see paragraph (c) of § 1.457-1.

Part 1.B. of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Applicability Date for Section 101 Regulations," explains:

> Section 1.101-6(b) of the proposed regulations provides that, for purposes of section 6050Y, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to reportable policy sales made after December 31, 2017, and to reportable death benefits paid after December 31, 2017. Section 1.101-6(b) of the proposed regulations further provides that, for any other purpose, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to transfers of life insurance contracts,

[4084] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

> or interests therein, made after the date the Treasury decision adopting the proposed regulations as final regulations is published in the Federal Register.
>
> Several commenters requested clarification regarding the applicability dates set forth in § 1.101-6(b) of the proposed regulations. Two of these commenters requested that the Treasury Department and the IRS clarify that the rules issued with respect to section 101(a)(3) apply to all transfers of life insurance contracts, or interests therein, made after December 31, 2017, or alternatively, that the Treasury Department and the IRS allow taxpayers to rely upon the rules in § 1.101-1 of the proposed regulations for transactions undertaken after December 31, 2017, and before the date that the Treasury Department adopts final rules. Another commenter recommended that application of the rules under section 101 (as well as the reporting obligations under section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register, but suggested that language should be included in the preamble to the final regulations to provide that taxpayers may rely on the proposed regulations for the period prior to the effective date of the final regulations.
>
> Because the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations, the definitions and rules set forth in § 1.101-1(b) through (g) of the final regulations apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. See §§ 1.101-6(b) and 1.6050Y-1(b) of the final regulations.
>
> The final regulations provide that, for other purposes, specifically for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) of the final regulations apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019. However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-6(b) provides:

> Notwithstanding paragraph (a) of this section, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4, § 1.1011(b) through (g) apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. For any other purpose, including for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019. However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the

> insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-1(b)(1)(i), "In general," (under (b)(1), "Transfer of an interest in a life insurance contract for valuable consideration") provides:

> In the case of a transfer of an interest in a life insurance contract for valuable consideration, including a reportable policy sale for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to the interest. For exceptions to this general rule for certain transfers for valuable consideration that are not reportable policy sales, see paragraph (b)(1)(ii) of this section. The application of section 101(d), (f) or (j), which is not addressed in paragraph (b) of this section, may further limit the amount of the proceeds excludable from gross income.

Before getting into the exceptions to the transfer-for-value rule, let's address the last sentence of Reg. § 1.101-1(b)(1)(i). Code § 101(d) provides that payments other than simply the death benefit on the date of death will be taxable. Code § 101(f) relates to "a flexible premium life insurance contract issued before January 1, 1985." Code § 101(j) relates to a policy owned by an employer of or business entity owned by an insured; see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

Part 1.B.2 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(b) of the Proposed Regulations," explains:

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from gross income for Federal income tax purposes under section 101(a)(1). However, if a life insurance contract or interest therein is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount received by reason of the death of the insured to the sum of the consideration paid for the contract or interest therein and any premiums and other amounts subsequently paid by the transferee with respect to the contract or interest therein. Section 101(a)(2)(A) and (B) provide two exceptions to this transfer for value rule. One exception (the "certain person exception") applies to transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer ("certain persons"). See section 101(a)(2)(B). The other exception (the "carryover basis exception") applies if the transferee's basis for determining gain or loss in the life insurance contract or interest therein is determined in whole or in part by reference to the transferor's basis in the contract or interest therein. See section 101(a)(2)(A). Under section 101(a)(3), which was added by section 13522 of the TCJA, neither of these exceptions to the transfer for value rule apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale.
>
> Section 1.101-1(b)(1)(i) of the proposed regulations provides the general transfer for value rule set forth in section 101(a)(2). Section 1.101-1(b)(1)(ii) of the proposed regulations sets forth the exceptions from this general rule for transfers for valuable consideration that are not reportable policy sales (the certain person exception and carryover basis exception provided in section 101(a)(2)). Section 1.101-1(b)(2) of the proposed regulations provides

rules regarding gratuitous transfers of interests in life insurance contracts, as well as transfers of only a part of an interest in a life insurance contract and bargain sales of an interest in a life insurance contract (that is, transfers that are in part gratuitous and in part transfers for valuable consideration). This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(b) of the proposed regulations.

A. Transfers to certain persons

One commenter on the proposed regulations described a life insurance policy subject to the section 101(a)(2) transfer for value rule as "tainted," in that death benefits paid under the policy are no longer fully excluded from income under section 101(a)(1). The commenter asked that the final regulations provide for removal of the "taint" by a transfer to the insured, as was permitted before the TCJA, and asked for clarification regarding whether a transfer of a policy to the insured must be a sale for fair market value to remove the "taint" of a transfer for valuable consideration. The commenter suggested that mistakes happen, including the mistake of not seeking tax advice from a professional who knows the section 101 rules, and that taxpayers should be able to take corrective measures to remove this "taint." The commenter noted that the insured may no longer have a business or other need for the current transferee to own the policy and may wish to hold the policy to protect the insured's family, or the insured may regret selling the policy and wish to buy the policy back after the policy was transferred in a reportable policy sale. The commenter pointed out that § 1.101-1(b)(3)(ii) of the existing regulations (not yet revised to reflect TCJA changes to section 101) currently provides such a corrective measure, allowing the "taint" to be removed by a transfer of the policy to certain persons. However, § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations makes this corrective measure unavailable to the extent that the transfer to those certain persons was preceded by a transfer of the policy for valuable consideration in a reportable policy sale. The commenter also noted that § 1.101-1(b)(3)(ii) of the existing regulations does not require the corrective transfer to be a sale for fair market value, and that § 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not impose such a requirement. The commenter suggested that Example 1, Example 2, and Example 3 in § 1.101-1(g)(1), (2), and (3) of the proposed regulations, read together, however, appear to require that the transfer to the insured be a sale for fair market value to clear the "taint" of a prior transfer for valuable consideration. The commenter asked for clarification on this point. The commenter suggested that the transfer to the insured be available as a corrective measure even if that transfer was preceded by a reportable policy sale, and, to prevent any possible abuse, that the insured be required to pay fair market value if the policy previously had been transferred in a reportable policy sale.[4085]

Section 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not explicitly require that the valuable consideration for a transfer of an interest in a life insurance contract be equal to the interest's fair market value, but, in the case of a bargain sale, the rules implementing the provisions of section 101 are applied separately to the sale and gift portions of the transferred interest. Under § 1.101-1(b)(2)(iii) of the proposed regulations, part of the transfer in a bargain sale is treated as a gratuitous transfer subject to § 1.101-1(b)(2)(i) of the proposed regulations. Example 1, Example 2, and Example 3 in § 1.101-1(g)(1), (2), and (3) of the proposed regulations are intended to illustrate the application of the rules implementing the changes made by the TCJA. For the sake of simplicity, the consideration

[4085] [My footnote:] I was that commenter.

in these examples equals fair market value, so the bargain sale rules do not apply. The final regulations include an example that illustrates the application of the bargain sale rules. See Example 7 in § 1.101-1(g)(7) of the final regulations.

In response to the comments received, the final regulations provide for a fresh start with respect to an interest gratuitously transferred to the insured, provided the interest has not previously been transferred for value in a reportable policy sale. See § 1.101-1(b)(2)(i) of the final regulations. Example 2 in § 1.101-1(g)(2) of the final regulations illustrates the application of this rule. The final regulations also provide for a fresh start with respect to an interest (or portion thereof) that is transferred to the insured following a reportable policy sale of the interest for valuable consideration, but only to the extent that the insured pays fair market value for the interest and only with respect to the interest (or relevant portion thereof) transferred to the insured that is not subsequently transferred in a transfer for valuable consideration or in a reportable policy sale. See § 1.101-1(b)(1)(ii)(B)(3) of the final regulations. The application of this rule is illustrated in revised Example 6, new Example 7, new Example 8, and new Example 9 in § 1.101-1(g)(6), (g)(7), (g)(8), and (g)(9) of the final regulations.

B. Gratuitous Transfers

Under § 1.101-1(b)(2)(i) of the proposed regulations, the amount of the policy proceeds attributable to a gratuitously transferred interest in a life insurance policy that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and the premiums and other amounts subsequently paid by the transferee with respect to the interest. Unlike the existing regulations, the proposed regulations do not provide a special rule for a gratuitous transfer made by or to certain persons.[1] As explained in the preamble to the proposed regulations, such a rule is not required by section 101(a), and a special rule for these transfers could be subject to abuse. *See* 84 FR 11009, 11017.

[1] Under § 1.101-1(b)(2) of the existing regulations, in the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, the amount of the proceeds attributable to such policy or interest that is excludable from the transferee's gross income under section 101(a) is, as a general rule, limited to the sum of the amount which would have been excludable by the transferor if no such transfer had taken place and any premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred is excludable from the transferee's gross income.

Section 1.101-1(b)(2)(i) of the proposed regulations applies to any gratuitous transfer of an interest in a life insurance contract, "including a reportable policy sale that is not for valuable consideration." One commenter requested that this language be deleted, asserting that including gratuitous transfers within the definition of reportable policy sales is not consistent with section 101.[2] The commenter noted that the title of section 101(a)(3) is "Exception to valuable consideration rules for commercial transactions," which the commenter asserted makes clear that a reportable policy sale can occur only if there has been a transfer for valuable consideration. The commenter further asserted that the provisions of section 101(a)(3)(A) and (B) limit the relevance of reportable policy sales to those situations in which a taxpayer needs to determine whether one of the section 101(a)(2) exceptions applies and, because those exceptions are never relevant for gratuitous transfers, reportable policy sales are never relevant for gratuitous transfers.

[2] The commenter also asserted that this language creates unnecessary and confusing reporting requirements under section 6050Y for gift transfers and is inconsistent with the statutory language, which, according to the commenter, indicates that a reportable policy sale must be a transfer for value. The commenter's concerns about reporting are discussed in section 10.A of this Summary of Comments and Explanation of Revisions.

The TCJA added section 101(a)(3)(A) to provide that the two pre-existing exceptions to the transfer for value rules no longer apply if the transfer is a reportable policy sale. Section 101(a)(3)(B) defines a reportable policy sale as any acquisition of an interest in a life insurance contract in the absence of the described relationship between the acquirer and insured. Although the availability of exceptions from the transfer for value rules is not directly relevant to a gratuitous transfer standing alone, the acquisition of an interest in a contract by an acquirer that does not have the described relationship with the insured, including a gratuitous transfer, may affect the exclusion of the policy proceeds from gross income under section 101(a) and the regulations thereunder if there are subsequent transfers. Consistent with the statutory language, the definition of a reportable policy sale in the final regulations does not exclude gratuitous transfers.

Reg. § 1.101-1(b)(2), "Other transfers," provides:

(i) *Gratuitous transfer of an interest in a life insurance contract*. To the extent that a transfer of an interest in a life insurance contract is gratuitous, including a reportable policy sale that is not for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.

(ii) *Partial transfers*. When only part of an interest in a life insurance contract is transferred, the transferor's exclusion is ratably apportioned between or among the several parts. If multiple parts of an interest are transferred, the transfer of each part is treated as a separate transaction, with each transaction subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

(iii) *Bargain sales*. When the transfer of an interest in a life insurance contract is in part a transfer for valuable consideration and in part a gratuitous transfer, the transfer of each part is treated as a separate transaction for purposes of determining the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1). Each separate transaction is subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

"Gratuitous" is not defined anywhere, but the context of Reg. § 1.101-1(b)(2) suggests that it means any transfer that is not for valuable consideration. Reg. § 1.101-1(f)(5), reproduced in the text accompanying fn 4067, refers to "cash or other consideration reducible to a money value." Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4086] – as a transfer for valuable consideration.

The last sentence of Reg. § 1.101-1(b)(2)(i) is an important cleansing rule that the final regulations added after I asked for it. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4087]

Reg. § 1.101-1(b)(3), "Determination of amounts paid by the transferee," provides:

> For purposes of paragraphs (b)(1) and (2) of this section, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e).

II.Q.4.b.ii.(b). Interest in a Life Insurance Contract

The preamble to the proposed regulations explains:[4088]

> The proposed regulations provide that any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value is a transfer for valuable consideration. See § 1.101-1(f)(5) of the proposed regulations; see also § 25.2512-8 ("[a] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded"). An interest in a life insurance contract (also referred to as a life insurance policy) is held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, or by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the insurance policy as described in § 20.2042-1(c)(2). See § 1.101-1(e)(1) of the proposed regulations. The enforceable right to designate a contract beneficiary is an interest in a life insurance contract. *Id.* Any person named as the owner in a life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract. *Id.*
>
> The transfer of an interest in a life insurance contract includes the transfer of any interest in the life insurance contract as well as any transfer of the life insurance contract itself (meaning a transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract). See § 1.101-1(e)(2) of the proposed regulations. For instance, the creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. *Id.* However, the revocable designation of a beneficiary of the policy proceeds does not constitute a

[4086] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[4087] Especially text accompanying fn 4123, as well as Example (2) that is discussed in the text accompanying fn 4117.
[4088] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> transfer of an interest in a life insurance contract to the beneficiary until the designation becomes irrevocable other than by reason of the death of the insured. *Id.* For purposes of this rule, a beneficiary designation is not revocable if the person with the right to designate the beneficiary of the contract has an enforceable contractual obligation to designate a particular contract beneficiary. The pledging or assignment of a policy as collateral security also is not a transfer of an interest in a life insurance contract. *Id.* In response to comments received on Notice 2018-41 suggesting that the initial owner of a life insurance contract should not be considered an "acquirer" for purposes of section 6050Y(a), § 1.101-1(e)(2) of the proposed regulations clarifies that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract.

Part 1.B.4 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(e) of the Proposed Regulations," explains:

> Section 1.101-1(e) of the proposed regulations defines the terms used to determine whether there has been an acquisition of an interest in a life insurance contract. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions in § 1.101-1(e) of the proposed regulations.
>
> **A. Interest in a Life Insurance Contract**
>
> Under § 1.101-1(e)(1) of the proposed regulations, an "interest in a life insurance contract" is generally defined as the interest held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2). Section 1.101-1(e)(2) of the proposed regulations provides that the term "transfer of an interest in a life insurance contract" means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. Under § 1.101-1(e)(3) of the proposed regulations, the acquisition of an interest in a life insurance contract may be direct or indirect, as described in § 1.101-1(e)(3)(i) (defining "direct acquisition of an interest in a life insurance contract") and (ii) (defining "indirect acquisition of an interest in a life insurance contract").
>
> One commenter on the proposed regulations suggested that, in a life settlement transaction in which a securities intermediary holds legal title to the acquired life insurance contract as nominee for the new beneficial owner of the life insurance contract pursuant to a securities account agreement, the new beneficial owner does not acquire an interest in the life insurance contract under § 1.101-1(e)(3) of the proposed regulations, even though the new beneficial owner controls and enjoys all of the benefits of the life insurance policy, because the new beneficial owner neither acquires legal title to the life insurance policy nor holds an ownership interest in the securities intermediary holding legal title. However, under the proposed regulations, the new beneficial owner acquires an interest in the life insurance contract because it acquires control of all of the benefits of the life insurance policy. Any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations. In the situation described in the comment,

after the life settlement transaction, there are two persons who have an interest in the life insurance contract at issue: the legal title holder and the new beneficial owner. Example 16 of § 1.101-1(g)(16) of the final regulations illustrates a reportable policy sale in which one acquirer acquires legal title and another acquires beneficial ownership.

B. Section 1035 Exchanges[4089]

Section 1.101-1(e)(2) of the proposed regulations provides that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract. The preamble to the proposed regulations requests comments on whether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts. *See* 84 FR 11009, 11019.

One commenter on the proposed regulations recommended that no additional provisions be added to the proposed regulations for this circumstance. The commenter stated that the acquirer of a life insurance contract in a reportable policy sale would be unlikely to meet the requirements for an insurable interest in the insured and, consequently, would not be able to make a section 1035 exchange. In support of this position, the commenter explained that, in order for an exchange of policies to qualify as a section 1035 exchange, the owner of the new contract must be the same person who owned the old contract at the time of the exchange. The commenter also stated that an insurer can issue a new policy only when that new policy will meet state insurance laws requiring an insurable interest in the insured, and an insurable interest is generally based on a close familial relationship with the insured or a lawful and substantial financial interest in the continued life of the insured.

Another commenter recommended that the statement in § 1.101-1(e)(2) of the proposed regulations regarding section 1035 exchanges be deleted or amended to eliminate any suggestion that such transactions, by themselves, can lead to reportable policy sales. The commenter indicated that the statement suggests that the mere issuance of a new life insurance policy in a section 1035 exchange could (or perhaps would) give rise to a reportable policy sale and asserted that such treatment is unnecessary and would be inappropriate.

In support of this position, the commenter explained that, mechanically, a section 1035 exchange typically involves the assignment by the policyholder of the existing policy to the carrier, followed by the surrender of the policy and the application of the cash proceeds as a premium under a new policy issued to the same owner on the same insured's life. The commenter remarked that, although the new carrier acquires an interest in the old policy, that interest is immediately extinguished. The commenter also remarked that treating the exchange as a reportable policy sale is not necessary to serve any information collection purpose in the case of an exchange involving a new, different carrier, because the exchange must be reported to the IRS and the policyholder on a Form 1099-R. Additionally, the commenter suggested that, even if an exchange were viewed as potentially meeting the definition of a reportable policy sale, the new carrier should be

[4089] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn 4100 in part II.Q.4.b.ii.(c) "Reportable Policy Sale".

viewed as having a substantial business or financial relationship with the insured, considering that the carrier just issued a new policy on that individual's life.

The commenter suggested that, if there are specific transactions involving section 1035 exchanges that fall outside the normal situation described by the commenter, and the Treasury Department and the IRS determine that such atypical scenarios might give rise to reportable policy sales, the scope of any provision addressing those transactions should be limited to those particular transactions, so that doubt will not be cast on everyday policy exchanges.

The reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges was not intended to imply that the transfer of a policy to an insurance company in a section 1035 exchange would be a reportable policy sale. In response to the comments received on section 1035 exchanges, § 1.101-1(c)(2)(iv) of the final regulations provides that the acquisition of a life insurance contract by an insurance company in an exchange pursuant to section 1035 (such as the acquisition that would result from the assignment by the policyholder of the existing policy to the insurance company in exchange for the issuance of a new life insurance contract) is not a reportable policy sale.

The concern prompting the reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges related to the possibility that a policy transferred in a reportable policy sale subsequently could be exchanged for a new policy in an exchange pursuant to section 1035 and that, absent the reference in § 1.101-1(e)(2), the death benefits paid under the new policy might not be reported under section 6050Y(c). Under the final regulations, which adopt § 1.101-1(e)(2) of the proposed regulations as proposed, the issuance of a new life insurance contract to a policyholder in an exchange pursuant to section 1035 is a transfer of an interest in a life insurance contract (the newly issued life insurance contract) to the policyholder, which results in a direct acquisition of an interest in a life insurance contract (the newly issued life insurance contract) by the policyholder. *See* § 1.101-1(e)(2) and (3)(i) of the final regulations. The tax treatment of the newly issued life insurance contract under section 101 is not affected by the tax treatment of the policy for which it was exchanged. However, if the policyholder's acquisition of the newly issued contract constitutes a reportable policy sale, the rules generally applicable to reportable policy sales under section 101 and the regulations thereunder apply to determine the effect of the reportable policy sale on the tax treatment of the newly issued policy under section 101, and the rules generally applicable to reportable policy sales under section 6050Y and the regulations thereunder apply to determine whether section 6050Y reporting is required with respect to the reportable policy sale. The final regulations provide that the acquisition of a newly issued life insurance contract by a policyholder in an exchange pursuant to section 1035 is not a reportable policy sale, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange. *See* § 1.101-1(c)(2)(v) of the final regulations. If no such relationship exists at the time of the section 1035 exchange, the exchange is a reportable policy sale under § 1.101-1(c)(1) of the final regulations. The Treasury Department and the IRS have determined that no exception from the definition of reportable policy sale should apply in this situation. Based on comments received, this situation should rarely arise due to state law insurable interest requirements.

Should this situation arise, however, the policyholder, as an acquirer, must furnish the statement to the issuer required by section 6050Y(a)(2) and § 1.6050Y-2(d)(2) of the final regulations (the reportable policy sale statement or "RPSS"). *See* § 1.6050Y-2(f)(3) of the final regulations. In this case, the statement must be furnished to the issuer that issues the new life insurance contract. *See* § 1.6050Y-1(8)(ii) of the final regulations. However, the policyholder is not required to file the information return required by section 6050Y(a)(1) and § 1.6050Y-2(a) of the final regulations. *See* § 1.6050Y-2(f)(3). Also, because the policyholder is not only the acquirer, but is also the reportable policy sale payment recipient and the seller with respect to the reportable policy sale, the policyholder is not required to furnish the statement generally required to be furnished to the reportable policy sale payment recipient under § 1.6050Y-2(d)(1) of the final regulations. See § 1.6050Y-1(a)(15), (16), and (18) of the final regulations; § 1.6050Y-2(f)(3) of the final regulations. Additionally, although the issuer that issues the new life insurance contract receives an RPSS, it is not required to file a return or furnish a statement to the seller under section 6050Y(b) and § 1.6050Y-3 because the seller does not need the information that would be provided on the statement to properly report a section 1035 exchange. See § 1.6050Y-3(f)(3) of the final regulations.

However, if the issuer makes a payment of reportable death benefits under the newly issued life insurance contract, the issuer must report that payment under section 6050Y(c) and § 1.6050Y-4 of the final regulations, unless an exception under § 1.6050Y-4 applies.

C. Ordinary Course Trade or Business Acquisitions

Several commenters on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in ordinary course business transactions in which one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors should not be reportable policy sales. The proposed regulations include provisions that exclude certain of these transactions from the definition of reportable policy sales. These provisions include the definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, the special rule for indirect acquisitions in § 1.101-1(d)(4)(i) of the proposed regulations, and the definition of the term "indirect acquisition of an interest in a life insurance contract" in § 1.101-1(e)(3)(ii) of the proposed regulations.

Two commenters on the proposed regulations suggested that ordinary course business transactions (such as mergers or acquisitions) involving businesses that own life insurance contracts were not intended by Congress to fall within the meaning of a reportable policy sale and noted that the rules describing a reportable policy sale in the proposed regulations are very helpful in confirming that narrow intent. Another commenter stated that, although the legislative history does not elaborate on the intent of section 101(a)(3)(A) (which limits the carryover basis exception to transfers for value that fall outside the definition of reportable policy sale in section 101(a)(3)(B)), it is widely understood to be aimed at ensuring enforcement of the transfer for value rule with respect to newer forms of speculative transfers involving life insurance policies, rather than imposing new restrictions on legitimate business uses of life insurance. The commenter asserted that the preamble to the proposed regulations implicitly acknowledges this by stating that some provisions are meant to ensure that "certain ordinary course business transactions" will not be treated as reportable policy sales. In response to these comments supporting the ordinary course exclusions from the definition of reportable policy sales in the proposed regulations, those provisions are retained in the final regulations.

One commenter on the proposed regulations requested that the proposed regulations be revised to provide that any transfer of an interest in a life insurance contract as part of a tax-free reorganization conducted in the ordinary course of business is eligible for an exception to being treated as a reportable policy sale under section 101(a)(3)(B), regardless of whether the target survives the reorganization transaction. In this regard, the commenter recommended revising § 1.101-1(e)(3)(ii) of the proposed regulations, which defines the term "indirect acquisition of an interest in a life insurance contract," to specifically cover all transactions involving the acquisition of a C corporation that qualify for tax-free reorganization treatment unless, immediately prior to the acquisition, more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter also recommended adding an example to illustrate this point. The commenter concluded that § 1.101-1(e)(3)(ii) of the proposed regulations applies in the case of acquisition transactions in which the corporate existence of the target survives the acquisition (for instance, a taxable stock sale with no section 338 election, a reverse subsidiary merger structured to qualify as a tax-free reorganization under section 368(a)(2)(E), or a tax-free reorganization under section 368(a)(1)(B)) and appears not to apply in the case of acquisition transactions in which the target corporation is merged with and into the acquiring corporation and the target's separate corporate existence is terminated as of the merger date (for instance, a tax-free reorganization under section 368(a)(1)(A), (C), or (D) or section 368(a)(2)(D)).

Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest in the life insurance contract. However, for this purpose, the term "other entity" does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts immediately before the indirect acquisition. Accordingly, the acquisition of ownership of a C corporation that owns an interest in a life insurance contract is not an indirect acquisition of such an interest, and therefore is not a reportable policy sale, if no more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter thus is correct that § 1.101-1(e)(3)(ii) of the proposed regulations applies only in the case of indirect acquisitions of life insurance contracts (which include a tax-free reorganization in which the corporate existence of the target that holds an interest in a life insurance contract survives the acquisition), and not direct acquisitions of life insurance contracts (which include a tax-free reorganization in which the separate corporate existence of a target that holds an interest in a life insurance contract is terminated).

The commenter asserted that this disparate treatment (between policies transferred directly in tax-free asset reorganizations and indirectly in stock reorganizations) is inappropriate and not warranted as a matter of good tax policy. The commenter further asserted that all tax-free reorganizations should be eligible for an exception similar to the exception provided in § 1.101-1(e)(3)(ii) of the proposed regulations. The commenter noted that the proposed regulations provide certain exceptions that could apply to tax-free mergers in which the target goes out of existence and the surviving corporation continues to hold the life insurance contract, but asserted that having to determine in these types of tax-free mergers whether a particular exception applies on a contract-by-contract basis is unduly complex and a trap for the unwary. The commenter further asserted that this burdensome exercise does not appear to serve the purpose of the change in the statute, which is to address abusive transactions and a failure to report income when appropriate.

The final regulations do not adopt the commenters recommendation regarding amendments to § 1.101-1(e)(3)(ii). The exception in § 1.101-1(e)(3)(ii) of the proposed regulations is not targeted to acquisitions of C corporation stock in tax-free reorganizations, but instead is a relatively broad exception that applies to the acquisition of any interest in a C corporation, provided that no more than 50 percent of the C corporation's gross asset value consists of life insurance contracts. This exception is one of a number of exceptions in the proposed regulations intended to provide relief for indirect acquisitions in which acquisition of the underlying life insurance contract interest likely was not a significant motivating factor for the acquisition. The final regulations preserve the different results for stock and asset reorganizations because there are significant differences between these two types of reorganizations, and the Treasury Department and the IRS have concluded that those distinctions justify different treatment for purposes of sections 101 and 6050Y. In addition, no exception is provided in the final regulations that excludes reorganizations from the definition of a reportable policy sale. Rather, there are exclusions based on the application of the definitions of substantial relationships as mandated by the statute and exceptions for certain indirect acquisitions that may produce different results in different types of reorganizations.

One reason for treating indirect and direct acquisitions of life insurance contract interests differently is that an acquirer of an interest in an entity may have limited ability to determine what types of assets an entity owns, or to obtain from the entity information necessary to report on the entity's assets. Thus, for example, the proposed regulations provide a reportable policy sale exception for the acquisition of a small (five percent or less) interest in any entity, unless more than 50 percent of the entity's gross asset value consists of life insurance contracts. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. In addition, in the case of a C corporation, a corporate level income tax applies to corporate earnings in addition to income tax on distributions at the shareholder level. As a result, C corporations are not frequently used as vehicles for investing in life insurance contracts covering insureds with respect to which the corporation does not have a substantial business, financial, or family relationship at the time the contract is issued. For this reason, the proposed regulations provide a more generous exception for acquisitions of interests in a C corporation, provided that no more than 50 percent of the C corporation's gross asset value consists of life insurance contracts, as determined under § 1.101-1(f)(4) of the proposed regulations. *See* § 1.101-1(e)(3)(ii) of the proposed regulations.[4]

[4] Section 1.101-1(f)(4) of the final regulations clarifies that the gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under § 1.101-1(f)(1) of the final regulations as a beneficial owner of a partnership, trust, or other entity. Accordingly, the 50 percent test in § 1.101-1(e)(3)(ii) of the final regulations applies to a C corporation's assets and the assets held by any partnership, trust, or other entity beneficially owned by the C corporation.

After the TCJA amendments to section 101, the fact that the transfer of a life insurance contract occurs in a carryover basis transaction qualifying under section 101(a)(2)(A) (such as a tax-free reorganization) is no longer sufficient to avoid the limit on the amount of life insurance policy proceeds that are excludable from gross income under the section 101(a)(1) transfer for value rule. Rather, Congress provided that the carryover basis exception in section 101(a)(2)(A) does not apply unless the transferee also has a substantial family, business, or financial relationship with the insured. Under the proposed regulations, in the case of life insurance contracts transferred in an asset reorganization, the surviving corporation could, for example, establish that a substantial business relationship exists by determining that the life insurance policies transferred in the reorganization cover insureds who are key persons of, or materially participate in, an active trade or business of the acquirer as owners, employees, or contractors. *See* § 1.101-1(d)(2)(i) of the proposed regulations. The surviving corporation could also establish that a substantial business relationship exists by determining that the life insurance contracts cover insureds who either (i) are officers, directors or employees of the business being acquired immediately before the acquisition or (ii) previously were directors, highly compensated employees or highly compensated individuals within the meaning of section 101(j)(2)(A)(ii) and the surviving corporation will have ongoing financial obligations with respect to these individuals after the acquisition (such as retirement obligations). *See* § 1.101-1(d)(2)(ii) of the proposed regulations. Corporations must track this data annually for purposes of section 101(j) corporate owned life insurance (COLI) reporting obligations and related recordkeeping, so it should not be overly burdensome to obtain this information. Additionally, in an asset reorganization, it would in any case be necessary to review the life insurance contracts directly acquired on a contract-by-contract basis in order to update insurance contract ownership and beneficiary information with the relevant insurance company.

It is possible that an asset acquisition could result in the loss of the complete exclusion of death benefits from income with respect to some COLI policies that cover insureds who are not employed by the target immediately before the acquisition or employed by the acquirer after the acquisition and with respect to whom the acquirer has no ongoing obligations to pay retirement or other benefits. However, the Treasury Department and the IRS have not identified any clear policy reason why that tax benefit should carry over when ownership of the insurance policy is transferred. The indirect transfer exceptions in the proposed regulations that could permit COLI benefits to be retained with respect to some policies covering no-longer-connected officers, directors, and employees apply only when ownership of the insurance policy is not transferred, such as in a stock reorganization. These exceptions reflect a weighing by the Treasury Department and the IRS of information collection burdens versus potential for abuse in indirect acquisition scenarios.

The commenter also recommended modifying the language in Example 8 of § 1.101-1(g)(8) of the proposed regulations to clarify that the example is intended only to illustrate application of the rule under § 1.101-1(d) of the proposed regulations and is not intended to imply that, without the insured's current employment by the acquired corporation, the transaction would be treated as a reportable policy sale. Example 8 of § 1.101-1(g)(8) of the proposed regulations describes a tax-free reorganization in which a corporation transfers to an acquiring corporation its active trade or business and a life insurance policy on the life of a current employee that was acquired from the employee. The example concludes that, because the insured was an employee of the target corporation at the time of the tax-free reorganization, and the acquiring corporation carries on the acquired trade or business, the transfer in the tax-free reorganization is not a reportable policy sale because the acquirer has a substantial business relationship with the insured under § 1.101-1(d)(2)(ii) of the proposed regulations. The commenter observed that the example suggests that the transfer of the policy as part of the tax-free reorganization described in the example would not have qualified for an exception from being treated as a reportable policy sale under the proposed regulations absent the existence of the substantial business relationship. The commenter's understanding of the example is correct. The substantial business relationship is necessary for the tax-free reorganization in the example to avoid being treated as a reportable policy sale. As discussed in this section of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have not adopted the commenter's recommendation regarding amendments to § 1.101-1(e)(3)(ii), and therefore have not revised the example in the final regulations.

This commenter also recommended a related change to § 1.101-1(d)(4)(i) of the proposed regulations. Under § 1.101-1(d)(4)(i) of the proposed regulations, an indirect acquirer is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the indirect acquirer acquires its interest. Section 1.101-1(d)(4)(i) of the proposed regulations provides relief for acquirers who do not hold their interest in the relevant life insurance contracts directly, when the direct holder of those interests has a substantial business or financial relationship with the insured before and after the acquisition. The Department of Treasury and the IRS have determined that it is not appropriate to treat an indirect acquisition of an interest in a life insurance contract as a reportable policy sale when the direct owner of the interest in the life insurance contract does not change and the direct owner has a substantial family, business, or financial relationship with the insured. The commenter recommended modification of § 1.101-1(d)(4)(i) of the proposed regulations to eliminate what the commenter describes as disparate treatment that arises depending on the type of merger transaction the acquirer undertakes or whether after the merger the insured remains with the company or retains the right to retirement or other post-employment benefits.

First, the commenter observed that, in a tax-free merger in which the target goes out of existence, the direct holder of the life insurance contract no longer exists, and therefore would no longer have any relationship with the insured. Accordingly, the acquirer cannot be deemed to have a substantial business or financial relationship with the insured under § 1.101-1(d)(4)(i) of the proposed regulations. However, in a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would own the insurance contract directly. An acquirer that holds its interest in the relevant life insurance contract directly must determine whether it has a substantial family, business, or financial relationship with the insured under § 1.101-1(d) of the proposed regulations at the time of the acquisition.

Second, the commenter suggested that there are situations in which the insured's employment with the target company is terminated as a result of a merger or acquisition, and the insured has no continuing relationship with the surviving company that retains the life insurance contract. The commenter observed that, in such cases, the "after the date of the acquisition" prong of § 1.101-1(d)(4)(i) of the proposed regulations cannot be satisfied. The commenter recommended modifying § 1.101-1(d)(4)(i) of the proposed regulations to provide that the acquirer of an interest in a life insurance contract in a tax-free merger is deemed to have a substantial business or financial relationship with the insured if the target has a substantial business or financial relationship with the insured immediately prior to the merger, provided the acquirer does not otherwise transfer any interest in the life insurance contract in a transaction treated as a reportable policy sale. The commenter also recommended that the rule specifically state that the fact that the surviving company continues to hold, after the merger, the contract on the life of an individual with whom the target had a substantial financial or business relationship is the determinative factor under this modified rule.

> The proposed modification is not adopted because, although § 1.101-1(d)(4)(i) of the proposed regulations generally would not apply to the situations referenced by the commenter, the proposed regulations already include exceptions that may apply in the situations referenced by the commenter. In a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would have a direct acquisition of any interest in a life insurance contract acquired from the target. However, the acquirer does not have a reportable policy sale if the acquirer has a substantial family, business, or financial relationship with the insured. Under § 1.101-1(d)(2)(ii) of the proposed regulations, the surviving company has a substantial business relationship with the insured, and therefore has not acquired its interest in the life insurance contract on the insured's life in a reportable policy sale, if: (1) the insured is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition, and (2) the surviving company either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts. Accordingly, the proposed regulations already include a rule similar to the one requested by the commenter that is applicable to direct acquisitions of interests in life insurance contracts (such as acquisitions resulting from tax-free mergers in which the target does not survive).

Reg. § 1.101-1(e)(1), "Definition," provides:[4090]

> For purposes of this section and section 6050Y, the term interest in a life insurance contract means the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary. Any person named as the owner in the life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract.

Reg. § 20.2042-1(c)(2) is reproduced in the text accompanying fn 4336 in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

What happens when more than one person is named in a contract/policy as holding title or has possession? How does one define each person's interest? Presumably, one would review part II.Q.4.f Split-Dollar Arrangements.

Reg. § 1.101-1(e)(2), "Transfer of an interest in a life insurance contract," provides:

> For purposes of this section and section 6050Y, the term transfer of an interest in a life insurance contract means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. The creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. The following events are not a transfer of an interest in a life insurance

[4090] Part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance discusses an interest in a life insurance contact under Reg. § 1.101-1(e)(1) in the text accompanying fn 4127.

> contract: the revocable designation of a beneficiary of the policy proceeds (until the designation becomes irrevocable other than by reason of the death of the insured); the pledging or assignment of a policy as collateral security; and the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035.

The preamble to the proposed regulations explains:[4091]

> Under § 1.101-1(e)(3)(i) of the proposed regulations, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer). Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (directly or indirectly) an interest in the life insurance contract. For this purpose, the term "other entity" does not include a C corporation (as that term is defined in section 1361(a)(2)), unless more than 50 percent of the gross value of the assets of the C corporation (as determined under § 1.101-1(f)(4)) consists of life insurance contracts immediately before the indirect acquisition. Under § 1.101-1(f)(1) of the proposed regulations, a "beneficial owner" of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that partnership, trust, or other entity. The beneficial owner's interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities.
>
> Accordingly, under § 1.101-1(e)(3)(ii) of the proposed regulations, persons that acquire shares in a C corporation that holds an interest in a life insurance contract generally will not be considered to have an indirect acquisition of an interest in such contract. However, if the C corporation primarily owns life insurance contracts (or interests therein), any person that acquires shares in the C corporation will be considered to have an indirect acquisition of an interest in any life insurance contract held by the C corporation.

Reg. § 1.101-1(e)(3), "Acquisition of an interest in a life insurance contract," provides:[4092]

> For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.
>
> (i) *Direct acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer).
>
> (ii) *Indirect acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract. For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts

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[4091] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

[4092] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn 4129 in part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4099 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

(as determined under paragraph (f)(4) of this section) immediately before the indirect acquisition.

Elaborating on clause (ii) above, the preamble to the proposed regulations explains:[4093]

> Finally, in response to comments received on Notice 2018-41, certain indirect acquisitions of life insurance contracts, or interests in life insurance contracts, are excepted from the definition of a reportable policy sale. The limited definition of "indirect acquisition" under § 1.101-1(e)(3)(ii) of the proposed regulations means that shareholders acquiring an interest in a C corporation that holds an interest in one or more life insurance contracts will not be considered to have an indirect acquisition or reportable policy sale unless the C corporation primarily owns life insurance contracts (or interests therein). The proposed regulations also provide an exception from the definition of a reportable policy sale for an indirect acquisition of an interest in a life insurance contract if the direct holder of the interest acquired the interest in a reportable policy sale and reported the acquisition in compliance with section 6050Y(a) and § 1.6050Y-2 of the proposed regulations. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations. Also, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if (1) Immediately before the acquisition, no more than 50 percent of the gross value of the assets of the entity that directly holds the interest in the life insurance contract consists of life insurance contracts, and (2) the acquirer and his or her family members own five percent or less of the ownership interests in the entity that directly holds the interest in the life insurance contract. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. Section 1.101-1(f)(4) of the proposed regulations provides rules regarding the determination of the gross value of assets for this purpose.

Reg. § 1.101-1(f)(2), "C corporation," provides:

> The term C corporation has the meaning given to it in section 1361(a)(2).

Code § 1361(a)(2) is reproduced in fn 1713.

Reg. § 1.101-1(f)(4), "Gross value of assets," provides:

> (i) *Determination of gross value of assets*. Except as provided in paragraph (f)(4)(ii) or (iii) of this section, for purposes of paragraphs (c)(2)(iii)(B) and (e)(3)(ii) of this section, the term gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under paragraph (f)(1) of this section as a beneficial owner of a partnership, trust, or other entity.
>
> (ii) *Determination of gross value of assets of publicly traded entity*. For purposes of determining the gross value of assets of an entity that is publicly traded, if the entity's annual Form 10-K filed with the United States Securities and Exchange Commission (or equivalent annual filing if the entity is publicly traded in a non-U.S. jurisdiction) for the period immediately preceding a person's acquisition of an ownership interest in the entity does not contain information demonstrating that more than 50 percent of the gross value of the entity's assets consist of life insurance contracts, that person may

[4093] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

assume that no more than 50 percent of the gross value of the entity's assets consists of life insurance contracts, unless that person has actual knowledge or reason to know that more than 50 percent of the gross value of the entity's assets consists of life insurance contracts.

(iii) *Safe harbor definition of gross value of assets*. An entity may choose to determine the gross value of all the entity's assets for purposes of this section using the following alternative definition of gross value of assets:

(A) In the case of assets that are life insurance policies or annuity or endowment contracts that have cash values, the cash surrender value as defined in section 7702(f)(2)(A); and

(B) In the case of assets not described in paragraph (f)(4)(iii)(A) of this section, the adjusted bases (within the meaning of section 1016) of such assets.

II.Q.4.b.ii.(c). "Reportable Policy Sale" Defined

What is a "reportable policy sale" is important to determine whether a transfer for valuable consideration will cause a policy's death benefit to lose its income tax exclusion[4094] and for whether certain reporting must be done.[4095]

The preamble to the proposed regulations explains:[4096]

> Section 1.101-1(c) of the proposed regulations defines the term "reportable policy sale," which was introduced in section 101(a)(3). The proposed regulations provide that, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract is a "reportable policy sale" if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in that life insurance contract. See § 1.101-1(c)(1) of the proposed regulations.

Reg. § 1.101-1(c) describes what is a reportable policy sale.

Reg. § 1.101-1(c)(1), "In general," provides:[4097]

> Except as provided in paragraph (c)(2) of this section, a reportable policy sale for purposes of this section and section 6050Y is any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract.

[4094] See part II.Q.4.b.ii.(a) Income Tax Effect of a Reportable Policy Sale, as well as most of the rest of this part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4095] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.
[4096] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."
[4097] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4092 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

The preamble to the proposed regulations explains exceptions:[4098]

> The proposed regulations also provide several exceptions from the definition of reportable policy sale. The proposed regulations provide that the transfer of an interest in a life insurance contract between certain related entities is not a reportable policy sale. Specifically, a transfer between entities with the same beneficial owners is not a reportable policy sale if the ownership interest of each beneficial owner in each entity does not vary by more than a 20 percent ownership interest. See § 1.101-1(c)(2)(i) and (g)(10) of the proposed regulations. Also, a transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. tax return for the taxable year in which the transfer occurs is not a reportable policy sale. See § 1.101-1(c)(2)(ii) of the proposed regulations.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(c) of the Proposed Regulations," explains:

> Under section 101(a)(3)(B) and § 1.101-1(c)(1) of the proposed regulations, a reportable policy sale is, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. Exceptions to the definition of reportable policy sale for transfers between certain related entities are provided in § 1.101-1(c)(2)(i) and (ii) of the proposed regulations. Section 1.101-1(c)(2)(iii) of the proposed regulations sets forth exceptions from the definition of reportable policy sales for certain indirect acquisitions. This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(c) of the proposed regulations.
>
> **A. Pre-TCJA Acquisitions**
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> Two commenters on the proposed regulations requested clarification regarding the application of § 1.101-1(c)(2)(iii)(A) with respect to the indirect acquisition of an interest in a life insurance contract if the entity that directly holds the interest acquired the interest before January 1, 2018 (that is, before the existence of any reporting requirements under section 6050Y(a)). Both commenters recommended that an exception from the definition of reportable policy sale be provided with respect to the indirect acquisition of an interest in a life insurance contract by a person if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest before January 1, 2018. One commenter recommended that, if the requested exception is not provided, the partnership, trust, or other entity in which the investment interest is purchased should be permitted to undertake the applicable reporting, instead of requiring the investor to navigate the complexities of the reporting requirements. This commenter also suggested that, if the requested exception is provided, the partnership, trust, or other entity could file an information return with the IRS for its portfolio of policies acquired prior to January 1, 2018, as a transition solution. However, the other commenter suggested that the partnership, trust, or other entity may not have tracked or retained information sufficient to satisfy the reporting requirements under section 6050Y with respect to interests acquired before January 1, 2018.

[4098] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

In response to these comments, § 1.101-1(c)(2)(iii)(A) of the final regulations provides an exception from the definition of reportable policy sale with respect to the indirect acquisition of an interest in a life insurance contract by a person if a partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.[3]

[3] As discussed in section 1.A of this Summary of Comments and Explanation of Revisions, the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. Section 3.B of this Summary of Comments and Explanation of Revisions describes changes adopted in § 1.101-1(c)(2)(iii)(A) of the final regulations in response to other comments requesting expanded indirect acquisition exceptions.

B. Additional Requests for Expanded Indirect Acquisition Exceptions

One commenter on the proposed regulations identified the existence of a possible technical issue with § 1.101-1(c)(2)(iii)(A) of the proposed regulations, which provides an exception from reportable policy sale status for certain indirect acquisitions. The commenter noted that, under this provision, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest in a reportable policy sale that was reported in compliance with section 6050Y(a) and the regulations thereunder. The commenter described a fact pattern in which legal title to a life insurance contract is held by a nominee (for example, a securities intermediary) on behalf of a partnership, trust, or other entity (for example, an investment fund). The commenter concluded that, in this fact pattern, the exception in § 1.101-1(c)(2)(iii)(A) of the proposed regulations cannot apply to an investor in the partnership, trust, or other entity because the investor's ownership interest is in the partnership, trust, or other entity (which does not hold a direct interest in the life insurance contract), not in the nominee (which directly holds the legal interest in the life insurance contract). The commenter also recommended that § 1.101-1(c)(2)(iii)(A) be revised to clarify that the exception applies if reporting under section 6050Y is done by either the legal owner of the life insurance contract (such as a securities intermediary holding legal title as a nominee) or the beneficial owner of the life insurance policy that controls the life insurance contract under a securities account agreement (such as an investment fund).

In the fact pattern described in the comment letter, the partnership, trust, or other entity in which the investor acquires an ownership interest holds an interest in the life insurance contract. An interest in a life insurance contract is not limited to legal ownership of the contract. Instead, any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or acquires the right to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations.

The partnership, trust, or other entity described by the commenter presumably would hold such an interest directly, even though legal title to the life insurance contract is held by a nominee or other intermediary. By acquiring an interest in the partnership, trust, or other entity, the investor indirectly would acquire a beneficial interest in the life insurance contract. The exception in § 1.101-1(c)(2)(iii)(A) of the proposed regulations would apply to this indirect acquisition if the partnership, trust, or other entity reported its acquisition of the beneficial interest in the contract in compliance with section 6050Y(a). The commenter's recommended revision to § 1.101-1(c)(2)(iii)(A) of the proposed regulations therefore is not adopted in the final regulations.

The commenter also proposed that § 1.101-1(c)(2)(iii)(A) of the proposed regulations be modified to apply if "the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2."

This change is adopted in the final regulations, which also clarify that the partnership, trust, or other entity must be a partnership, trust, or other entity in which an ownership interest is being acquired. As modified, the exception applies to the indirect acquisition of an interest in a life insurance contract by a person acquiring an ownership interest in a partnership, trust, or other entity that holds the interest in the life insurance contract, regardless of whether the person's ownership interest in the partnership, trust, or other entity that reported its acquisition of the interest in the life insurance contract is direct or indirect and regardless of whether that partnership, trust, or other entity acquired its interest in a direct or indirect acquisition, provided the partnership, trust, or other entity acquired its interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2 or, as discussed in section 3.A of this Summary of Comments and Explanation, acquired its interest before January 1, 2019.

One commenter on the proposed regulations reiterated its previous request, made in comments on Notice 2018-41, that an exception from the reporting requirements of section 6050Y be provided with respect to an indirect acquisition of an interest in a life insurance contract by any investor that acquires a 5 percent or less economic and voting interest in an investment vehicle that holds, directly or indirectly, life insurance policies, with the added proviso that the investor must not be an officer or director of the investment vehicle. Section 1.101-1(c)(2)(iii)(B) of the proposed regulations provides that the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the acquirer and his or her family members own, in the aggregate, 5 percent or less of the partnership, trust, or other entity that directly holds the interest in the life insurance contract, but this exception applies only if, immediately before the acquisition, no more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts.

The final regulations do not adopt the proposed change because, if more than 50 percent of an entity's asset value is life insurance contracts, investment in life insurance contracts is likely the entity's primary business activity, and it is reasonable to expect even small investors to be able to determine the primary activity of the business they are investing in, regardless of whether they are also officers or directors of the entity. In addition, any investor that does not qualify for the exception set forth in § 1.101-1(c)(2)(iii)(B) of the final regulations because more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts may still qualify for the exception set forth in § 1.101-1(c)(2)(iii)(A) of the final regulations if a partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired the interest before

January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

> Separately, § 1.101-1(c)(2)(iii)(B) of the final regulations clarifies that, if the partnership, trust, or other entity in which the acquirer is directly acquiring an ownership interest indirectly holds an interest in one or more life insurance contracts, (i) the assets of the partnership, trust, or other entity in which the ownership interest is being acquired are tested to determine whether more than 50 percent of the gross value of the assets of that partnership, trust, or other entity consists of life insurance contracts, and (ii) the ownership interest in that partnership, trust, or other entity held by the acquirer and his or her family members after the acquisition is tested to determine whether they hold more than a 5 percent ownership interest in the entity. The assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract and the interest in that partnership, trust, or other entity held by the acquirer and his or her family member are tested only if the acquirer is directly acquiring an ownership interest in that partnership, trust, or other entity.

Reg. § 1.101-1(c)(2), "Exceptions," provides:

> None of the following transactions is a reportable policy sale:[4099]
>
> (i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity. In a series of transfers, the prior sentence is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity. For purposes of this paragraph (c)(2)(i), each beneficial owner of a trust is deemed to have an ownership interest determined by the broadest possible exercise of a trustee's discretion in that beneficial owner's favor. Paragraph (g)(13) (Example 13) of this section provides an illustration of the application of this paragraph (c)(2)(i).
>
> (ii) A transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.
>
> (iii) The indirect acquisition of an interest in a life insurance contract by a person if—
>
> (A) A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2; or
>
> (B) Immediately before the acquisition, no more than 50 percent of the gross value of the assets (as determined under paragraph (f)(4) of this section) of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract, and in which an ownership interest is being directly acquired, consists of life insurance contracts, provided that, after the acquisition, with respect to that

[4099] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4092 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

partnership, trust, or other entity, the person indirectly acquiring the interest in the life insurance contract and his or her family members own, in the aggregate-

(1) With respect to an S corporation, stock possessing 5 percent or less of the total combined voting power of all classes of stock entitled to vote and 5 percent or less of the total value of shares of all classes of stock of the S corporation;

(2) With respect to a trust or decedent's estate, 5 percent or less of the corpus and 5 percent or less of the annual income (taking into account, for the purpose of determining any person's ownership interest, the maximum amount of income and corpus that could be distributed to or held for the benefit of that person); or

(3) With respect to a partnership or other entity that is not a corporation or a trust, 5 percent or less of the capital interest and 5 percent or less of the profits interest.

(iv) The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to section 1035.

(v) The acquisition of a life insurance contract by a policyholder in an exchange pursuant to section 1035, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.

Reg. § 1.101-1(c)(2)(v) requires the holder of a policy on the insured who does a Code § 1035 exchange for a replacement policy on the insured to have a substantial family, business, or financial relationship with the insured or risk its interest in the replacement policy being tainted as having been transferred in a reportable policy sale.[4100] This creates concerns when an employer uses a cash value life insurance policy to fund its payments of post-retirement benefits for a living former employee. (It would not create a concern when funding the post-mortem purchase of the retiree's interest in the employer or any other obligations that mature by reason of the employee's death.)[4101]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[4102] which provides:

> *Example 13*. Partnership X and Partnership Y are owned by individuals A, B, and C. A holds 40% of the capital and profits interest of Partnership X and 20% of the capital and profits interest of Partnership Y. B holds 35% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. C holds 25% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. Partnership X is the initial policyholder of a $100,000 insurance policy

[4100] For the preamble discussing this issue, see fn 4089 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[4101] See Reg. § 1.101-1(d)(2)(ii).

[4102] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

> on the life of A. Partnership Y purchases the policy from Partnership X. Under paragraph (c)(2)(i) of this section, this transfer is not a reportable policy sale because the ownership interest of each beneficial owner in Partnership X does not vary from that owner's interest in Partnership Y by more than a 20% ownership interest. A's ownership varies by a 20% interest, B's ownership varies by a 5% interest, and C's ownership varies by a 15% interest.

Reg. § 1.101-1(g)(15)[4103] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[4104] in paragraph (g)(14) of this section, except that A is no longer an employee of Partnership X, and Partnership X has no substantial family, business, or financial relationship with A, when B acquires the profits interest in Partnership X. Also, B acquires only a 5% profits interest in exchange for a cash payment of $500,000. Partnership X does not own an interest in any other life insurance policies, and the gross value of its assets is $10 million. Although neither Partnership X nor B has a substantial family, business, or financial relationship with A at the time of B's indirect acquisition of an interest in the policy covering A's life, because B's profits interest in Partnership X does not exceed 5%, and because no more than 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of this section applies, and B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale.

Reg. § 1.101-1(c)(1) above stated that a reportable policy sale can apply only if, at the time of the acquisition, the acquirer has "no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract." Reg. § 1.101-1(d) describes these substantial relationships.

The preamble to the proposed regulations explains:[4105]

> Section 1.101-1(d) of the proposed regulations defines the terms "substantial family relationship," "substantial business relationship," and "substantial financial relationship." Under section 1.101-1(d)(1) of the proposed regulations, a "substantial family relationship" is the relationship between an individual and any family member of that individual as defined in § 1.101-1(f)(3) of the proposed regulations. A substantial family relationship also exists between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce. See § 1.101-1(d)(1) of the proposed regulations. Additionally, a substantial family relationship exists between the insured and an entity if all of the entity's beneficial owners have a substantial family relationship with the insured. *Id.*
>
> Section 1.101-1(d)(2) describes the two situations in which a substantial business relationship exists between the acquirer and insured: (1) The insured is a key person (as

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4103 Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

4104 [Not in the regulation - click to go to:] Example 14.

4105 Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

defined in section 264) of, or materially participates (as defined in section 469 and the corresponding regulations) in, an active trade or business as an owner, employee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer, and (2) the acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business, if certain requirements are met. See § 1.101-1(d)(2)(i) and (ii) of the proposed regulations.

Comments received on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in certain ordinary course business transactions involving the acquisition of a trade or business should not be considered reportable policy sales, including ordinary course business transactions whereby one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors. The definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, as well as certain other provisions in the proposed regulations, are intended to exclude certain of these transactions from the definition of reportable policy sales.

Section 1.101-1(d)(3) of the proposed regulations describes the three situations in which a substantial financial relationship exists between the insured and the acquirer: (1) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable; (2) the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured; or (3) the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. See § 1.101-1(d)(3)(i) through (iii) of the proposed regulations.

The proposed regulations also specify that the fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (all relationships that are covered by an exception from the transfer for value rule) is not sufficient to establish a substantial business or financial relationship, nor is such status required to establish a substantial business or financial relationship. See § 1.101-1(d)(4)(ii) of the proposed regulations. The proposed regulations also clarify that, for purposes of determining whether the acquirer in an indirect acquisition of an interest in a life insurance contract has a substantial business or financial relationship with the insured, the acquirer will be deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest. See § 1.101-1(d)(4)(i) of the proposed regulations. Accordingly, the acquirer in an indirect acquisition may establish a substantial business or financial relationship with the insured based on the acquirer's own relationship with the insured or the relationship between the insured and the direct holder of the interest in the life insurance contract.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(d) of the Proposed Regulations," explains:

> Section 1.101-1(d) of the proposed regulations defines the terms substantial family relationship, substantial business relationship, and substantial financial relationship, and provides special rules for applying these definitions. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions and special rules in § 1.101-1(d) of the proposed regulations.
>
> **A. Beneficial Owners With a Combination of Substantial Relationships**
>
> Under § 1.101-1(d)(1) of the proposed regulations, a substantial family relationship exists between the insured and a partnership, trust, or other entity if all of the beneficial owners of that partnership, trust, or other entity have a substantial family relationship with the insured. A partnership, trust, or other entity may itself have a substantial business or financial relationship with the insured under § 1.101-1(d)(2) or (3) of the proposed regulations.
>
> One commenter on the proposed regulations recommended that a transfer to a trust, partnership, or other entity not be a reportable policy sale within the meaning of section 101(a)(3) if all of the beneficial owners of the trust, partnership, or other entity have a substantial family, business, or financial relationship with the insured.[4106] The Treasury Department and the IRS have determined it would be appropriate to expand the definition of substantial family, business, or financial relationship to include the relationship between the insured and a trust, partnership, or other entity, every beneficial owner of which has a substantial family, business, or financial relationship with the insured. Accordingly, § 1.101-1(d)(4)(iii) of the final regulations provides this expanded definition.
>
> The commenter also suggested that the definition of "family member" under § 1.101-1(f)(3) should include charities to which the insured has given substantial financial support or significant volunteer support. Another commenter suggested that a trust with beneficiaries that include both individual family members and a charity with a substantial financial relationship to the insured should qualify as a "family member."[4107] Under § 1.101-1(d)(3)(iii) of the proposed regulations, a substantial financial relationship exists between the insured and acquirer if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. Under either of the approaches suggested by the commenters, the acquisition of an interest in a life insurance contract by a trust with beneficiaries that include both individuals who are family members of the insured and a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations would not be a reportable policy sale. The Treasury Department and the IRS agree that the existence of a trust beneficiary that is a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations should not cause a transfer to that trust to be a reportable policy sale. However, rather than expanding the definition of "family member" under § 1.101-1(f)(3) of the proposed regulations as suggested by the commenters, the Treasury Department and

[4106] [my footnote:] I was that commenter (one of only 12 comments submitted); see https://www.thompsoncoburn.com/docs/default-source/blog-documents/gorin-transfer-for-value-comments.pdf. Discussing with ACTEC Fellow Michael Van Cise's the comment he was making below got me thinking more about this issue.

[4107] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

the IRS have adopted a more direct and expansive approach to address the commenters' concerns by adding a new rule in the final regulations providing that any combination of the described substantial relationships between a trust's beneficiaries and the insured is sufficient to qualify the transfer to that trust for the reportable policy sale exclusion. See § 1.101-1(d)(4)(iii) of the final regulations. As a result, under the final regulations, there is no need to also expressly treat a trust established and maintained for the primary benefit of the insured or one or more of the insured's family members as a family member of the insured. Therefore, the final regulations do not include such a trust in the definition of family member.

B. Substantial Financial Relationships With Charities

Under § 1.101-1(d)(3)(iii) of the proposed regulations, the acquirer of an interest in a life insurance contract has a substantial financial relationship with the insured if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. One commenter on the proposed regulations suggested that this provision be expanded to include any other such organization with which the insured has substantial personal ties, such as the donor or a family member having benefitted from the charitable organization's services in some manner.[4108] The commenter stated that it is not uncommon for a donor to both (i) contribute very modestly, if at all, to a charity during life because the donor is concerned about having sufficient retirement income, and (ii) want to benefit the charity when the donor no longer needs to preserve retirement income sources. The commenter also stated that donors often benefit charities through either a split interest trust described in section 170(f)(2) or a bargain sale described in § 1.1011-2.

The Treasury Department and IRS have not adopted this suggestion in the final regulations because it would be challenging to determine when personal ties with a charity are substantial enough to constitute a substantial financial relationship with the insured, in the absence of a significant donation of time or property. Also, there generally will be little detriment to a charity as a result of an acquisition (whether gratuitous or for value) of an interest in a life insurance contract in a reportable policy sale. Nevertheless, as discussed later in this section, the final regulations provide that the category of charities considered to have a substantial financial relationship with an insured may be expanded in the future in guidance published in the Internal Revenue Bulletin.

Treating a gratuitous transfer of an interest in a life insurance contract (or the part of the transfer that is gratuitous, in the case of a bargain sale) as a reportable policy sale does not affect the amount of proceeds excludable by the gratuitous transferee. Section 1.101-1(b)(2)(i) of the final regulations applies to all gratuitous transfers of interests in life insurance contracts and generally provides that the transferee in a gratuitous transfer of an interest in a life insurance contract steps into the shoes of the transferor and may exclude death benefits paid under the contract from gross income to the same extent that the transferor would have been able to exclude the benefits, in addition to the premiums and other amounts paid by the transferee. Furthermore, treatment of a gratuitous transfer as a reportable policy sale does not result in reporting obligations for the gratuitous transferee because the gratuitous transferor is not a reportable policy sale payment recipient. See §§ 1.6050Y-1(a)(16) and 1.6050Y-2(a) of the final regulations.

[4108] [my footnote:] I was that commenter; see fn 4106.

Even if a charity purchased some or all of its interest in a life insurance contract for valuable consideration, a charity generally is not subject to Federal income tax on its income (including insurance policy proceeds) unless the income arises from an unrelated trade or business. Thus, the charity's obligation in case of a purchase generally would be limited to acquirer reporting under § 1.6050Y-2, which merely requires providing on Form 1099-LS information that should be readily available to the charity. This reporting provides important information regarding the sale to reportable policy sale payment recipients and the IRS.

In response to the commenters concerns, however, the final regulations provide that the IRS may publish guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) describing other situations in which a substantial financial relationship exists between the insured and an acquirer that is an organization described in sections 170(c), 2055(a), and 2522(a). See § 1.101-1(d)(3)(iii) of the final regulations.

C. Substantial Financial Relationships and BOLI Pooling Transactions

One commenter on the proposed regulations requested confirmation that a reportable policy sale will not arise when a life insurance policy is involved in a transaction that pools bank-owned life insurance (BOLI). The commenter explained that businesses, such as banks, commonly promise certain pre-and post-retirement benefits to their employees, such as retiree health care benefits, which can result in substantial liabilities for the businesses that must be reflected on their financial statements. The commenter described BOLI as permanent, cash value life insurance coverage on the lives of a bank's officers, directors, and employees purchased by the bank to fund such obligations informally and to establish assets on its financial statements to offset liabilities for the promised benefits. The commenter stated that BOLI owners typically hold the policies until the death benefits become payable and use the benefits to fund the costs of the employee benefits or to recover such costs after the fact. The commenter described BOLI pooling transactions as transactions that pool the BOLI policies of multiple banks for the continued purpose of funding each bank's employee benefits, but in a more effective, centralized way. The commenter described the initial step of a BOLI pooling transaction as the transfer by multiple unrelated banks of their pre-existing BOLI policies to a partnership, in return for which each bank receives a partnership interest proportional to the value of its contributed policies. The commenter explained that the partnership holds and manages the contributed policies and distributes death benefits among the bank-partners pro rata based on their respective partnership interests, which is expected to help normalize cash flows from the policies.

The commenter asserted that BOLI pooling transactions are ordinary course business transactions that should not be treated as reportable policy sales because they are not speculative and can be distinguished from sales of policies to third parties because the intent and result is to pool the policies among all the original policyholders for the continued purpose of funding their employee benefit liabilities. The commenter noted that the IRS has issued private letter rulings that confirm, directly or indirectly, that the carryover basis exception to the transfer for value rule in section 101(a)(2) applies to a bank's contribution of BOLI policies to the partnership in a BOLI pooling transaction, thereby preserving the tax-free character of the death benefits when paid to the partnership. These rulings pre-date the addition of section 101(a)(3) to the Code. The reportable policy sale rules of section 101(a)(3) are in addition to the carryover basis exception of section 101(a)(2). As a result, policy transfers are ineligible for the carryover basis exception if no substantial family, business, or financial relationship exists between the acquirer of an interest in a life insurance contract and the insured under that contract at the time of the acquisition.

The commenter asserted that the proposed regulations support the requested treatment of BOLI pooling transactions because a substantial financial relationship exists between the acquirer and insured. A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. The commenter asserted that this provision applies in BOLI pooling transactions with respect to both the bank and the partnership as follows: (1) the partnership has a direct acquisition of life insurance policies, which it maintains to satisfy liabilities following the death of the insured, namely, the employee benefit liabilities of the bank-partners for which they originally purchased the policies; (2) the bank has an indirect acquisition of life insurance policies contributed by other banks to the partnership; and (3) the bank maintains its indirect interest in those policies to continue funding the same employee benefit liabilities. The commenter recommended clarification of the regulations to confirm this treatment, either by adding additional language to the definition of substantial financial relationship, or by adding an example that applies that provision to the BOLI pooling transaction. Alternatively, the commenter suggested a separate exception to the reportable policy sale definition.

The final regulations do not adopt the commenters requested changes because the changes would be inconsistent with the statute. The proposed regulations do not support, and were not intended to support, the requested treatment of BOLI pooling transactions.

First, the partnership described by the commenter does not have a substantial family, business, or financial relationship with the insureds under the proposed regulations. Specifically, it does not have a substantial financial relationship with any insured under § 1.101-1(d)(3)(ii) of the proposed regulations because it does not maintain the life insurance contract on the life of the insured to provide funds for the partnership to purchase assets or satisfy liabilities following the insured's death. As described by the commenter, the partnership maintains the life insurance contracts to provide its partners, the banks, with funds to satisfy the banks' employee benefit liabilities. Accordingly, the partnership's acquisition of the life insurance contracts in the circumstances described is a reportable policy sale that must be reported under section 6050Y and § 1.6050Y-2 of the proposed regulations.

Second, the definition of a substantial financial relationship in § 1.101-1(d)(3)(ii) of the proposed regulations was not intended to cover relationships as tenuous as those existing between the indirect acquirers (the banks) and the insureds in the BOLI pooling transactions described by the commenter. Section 1.101-1(d)(3)(ii) of the proposed regulations was intended to cover situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities, when the need for the asset purchases or liability payments results from the insured's death. In the situation described by the commenter, a bank does not have this kind of relationship with the insureds under life insurance contracts contributed to the partnership by other banks. However, in the circumstances described, because the partnership acquires the life insurance contracts in a reportable policy sale that must be reported under section 6050Y(a) and § 1.6050Y-2 of the proposed regulations, the bank's indirect acquisition of the life insurance contracts is not a reportable policy sale, provided the partnership complies with the reporting requirements. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations.

D. Substantial Financial Relationships Under § 1.101-1(d)(3)(ii)

> A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. As described in section 5.0 of this Summary of Comments and Explanation of Revisions, this definition was intended to apply in situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities following the death of the insured, when the need for the asset purchases or liability payments results from the insured's death. Accordingly, § 1.101-1(d)(3)(ii) of the final regulations revises the definition to provide that a substantial financial relationship exists between the acquirer and insured if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

Reg. § 1.101-1(d)(1), "Substantial family relationship," provides:

> For purposes of this section, a substantial family relationship means the relationship between an individual and any family member of that individual as defined in paragraph (f)(3) of this section. In addition, a substantial family relationship exists between an individual and his or her former spouse with regard to the transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce.

Reg. § 1.101-1(f)(3), "Family member," provides:

> With respect to any individual, the term family member refers to any person described in paragraphs (f)(3)(i) through (vi) of this section. For purposes of this paragraph (f)(3), full effect is given to a legal adoption, and a step-child is deemed to be a descendant. The family members of an individual include:
>
> (i) The individual;
>
> (ii) The individual's spouse or a person with whom the individual is in a registered domestic partnership, civil union, or other similar relationship established under state law;
>
> (iii) Any parent, grandparent, or great-grandparent of the individual or of the person described in paragraph (f)(3)(ii) of this section and any spouse of such parent, grandparent, or great-grandparent, or person with whom the parent, grandparent, or great-grandparent is in a registered domestic partnership, civil union, or other similar relationship established under state law;
>
> (iv) Any lineal descendant of the individual or of any person described in paragraph (f)(3)(ii) or (iii) of this section;
>
> (v) Any spouse of a lineal descendant described in paragraph (f)(3)(iv) of this section and any person with whom such a lineal descendant is in a registered domestic partnership, civil union, or other similar relationship established under state law; and
>
> (vi) Any lineal descendant of a person described in paragraph (f)(3)(v) of this section.

Reg. § 1.101-1(d)(2), "Substantial business relationship," provides:

> For purposes of this section, a substantial business relationship between the insured and the acquirer exists in each of the following situations:
>
> (i) The insured is a key person (as defined in section 264) of, or materially participates (within the meaning of section 469) in, an active trade or business as an owner, employee, or contractor, and at least 80 percent of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.
>
> (ii) The acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business if--
>
> (A) The insured—
>
> (1) Is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition; or
>
> (2) Was a director, highly compensated employee, or highly compensated individual within the meaning of section 101(j)(2)(A)(ii) of the acquired trade or business, and the acquirer, immediately after the acquisition, has ongoing financial obligations to the insured with respect to the insured's employment by the trade or business (for example, the life insurance contract is maintained by the acquirer to fund current or future retirement, pension, or survivorship obligations based on the insured's relationship with the entity or to fund a buy-out of the insured's interest in the acquired trade or business); and
>
> (B) The acquirer either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts.

For the above references to Code § 264, see fns 4055-4057 in part II.Q.4.a Funding the Buy-Sell. Under that provision, generally a key person is an officer or 20% owner, but the number of individuals who may be treated as key persons may be as few as five people.

For the above references to material participation under Code § 469, see part II.K.1.a.ii Material Participation and various other discussion in part II.K.1 Passive Loss Rules Generally.

For the above references to Code § 101(j), see part II.Q.4.g.i Analysis of Code § 101(j).

Reg. § 1.101-1(d)(2), "Substantial financial relationship," provides:

> For purposes of this section, a substantial financial relationship between the insured and the acquirer exists in each of the following situations:
>
> (i) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with

the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable.

(ii) The acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

(iii) The acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received from the insured either financial support in a substantial amount or significant volunteer support or that meets other requirements prescribed in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for establishing that a substantial financial relationship exists between the insured and the organization.

Neither the proposed regulations nor their preamble defines "common investment." Presumably this provides full latitude for buy-sell agreements among owners of a business entity.

Reg. § 1.101-1(d)(4), "Special rules," provides:

> Paragraphs (d)(4)(i), (ii), and (iii) of this section apply for purposes of determining whether a substantial relationship (whether family, business, or financial) exists under paragraph (d)(1), (2), or (3) of this section, respectively.
>
> (i) *Indirect acquisitions*. The acquirer of an interest in a life insurance contract in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest.
>
> (ii) *Acquisitions by certain persons*. The sole fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, is not sufficient to establish a substantial business or financial relationship with the insured. In addition, an acquirer need not be a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer to have a substantial business or financial relationship with the insured.
>
> (iii) *Acquisitions by those with differing types of substantial relationships*. A substantial family, business, or financial relationship exists between the insured and a partnership, trust, or other entity if each beneficial owner of that partnership, trust, or other entity has a substantial family, business, or financial relationship with the insured. For example, a substantial family, business, or financial relationship exists between the insured and a trust if each trust beneficiary is a family member of the insured or an organization described in paragraph (d)(3)(iii) of this section.

Reg. § 1.101-1(f)(1), "Beneficial owner," provides:

> A beneficial owner of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that entity. The interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities. For instance, an individual

> that directly owns an interest in a partnership (P1), which directly owns an interest in another partnership (P2), is an indirect beneficial owner of P2 and any assets or other entities owned by P2 directly or indirectly. For purposes of this paragraph (f)(1), the beneficial owners of a trust include those who may receive current distributions of trust income or corpus and those who could receive distributions if the trust were to terminate currently.

Note that the beneficial owners of a trust ***include*** those persons named above [emphasis added]. My understanding is that, in federal tax regulations, "includes" means "includes without limitation." Query whether that expansion of the definition means that one or more persons beyond the current potential distributees and immediate remaindermen need to be considered.

Reg. § 1.101-1(g)(14)[4109] elaborates on Reg. § 1.101-1(d)(4), providing:

> *Example 14*. Partnership X conducts an active trade or business and is the initial policyholder of a $100,000 insurance policy on the life of its full-time employee, A. A materially participates in Partnership X's active trade or business in A's capacity as an employee. Individual B acquires a 10% profits interest in Partnership X in exchange for a cash payment of $1,000,000. Under paragraphs (d)(1) through (3) of this section, B does not have a substantial family, business, or financial relationship with A. Under paragraph (d)(4)(i) of this section, however, B is deemed to have a substantial business relationship with A because, under paragraph (d)(2)(i) of this section, Partnership X (the direct policyholder) has a substantial business relationship with A. Accordingly, although the acquisition of the 10% partnership interest by B is an indirect acquisition of a 10% interest in the insurance policy covering A's life, the acquisition is not a reportable policy sale.

Reg. § 1.101-1(g)(16)[4110] elaborates on Reg. § 1.101-1(d), providing:

> *Example 16*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy for its fair market value. As a result of the sale, Bank X holds legal title to the life insurance contract as the nominee of Partnership B, and Partnership B has the enforceable right to designate the contract beneficiary. Under paragraphs (d)(1) through (4) of this section, neither Bank X nor Partnership B has a substantial family, business, or financial relationship with the insured, A, at the time of the sale. Accordingly, the transfer of legal title to the policy to Bank X is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies. The same is true of the transfer of the economic benefits of the policy to Partnership B. At a later date, Partnership B sells its economic interest in the policy to Partnership C for fair

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[4109] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4110] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

market value. Bank X continues to hold legal title to the life insurance contract, but now holds it as Partnership C's nominee. Partnership C has no substantial family, business, or financial relationship with the insured, A, under paragraphs (d)(1) through (4) of this section at the time of the transfer. Accordingly, Partnership C's acquisition of the economic interest in the policy from Partnership B is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies.

II.Q.4.b.ii.(d). Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale

Code § 101(a)(2) provides that the transfer for value rule does not apply:

> (A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or
>
> (B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

Thus, either, the substituted basis rule of Code § 101(a)(2)(A) or the permitted transferee rule of Code § 101(a)(2)(B) suffices to exclude from the transfer for value rules any transfer that is not a reportable policy sale.

The preamble to the proposed regulations explains:[4111]

> Section 1.101-1(b)(1)(i) of the proposed regulations provides that, in the case of a transfer of an interest in a life insurance contract for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to that interest. Consistent with section 101(a)(3), this general rule applies to all transfers of interests in life insurance contracts for valuable consideration that are reportable policy sales. Consistent with section 101(a)(2), this general rule also continues to apply to transfers of interests in life insurance contracts for valuable consideration that are not reportable policy sales, unless an exception set forth in section 101(a)(2) applies. See § 1.101-1(b)(1)(i) and (ii) of the proposed regulations. Section 1.101-1(b)(1)(ii)(A) of the proposed regulations applies to carryover basis transfers that are not also subject to § 1.101-1(b)(1)(ii)(B) of the proposed regulations. Section 1.101-1(b)(1)(ii)(B) of the proposed regulations applies to transfers to certain persons.
>
> Under § 1.101-1(b)(1)(ii)(A) of the proposed regulations, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations does not apply to the transfer of an interest in a life insurance contract for valuable consideration if (1) The transfer is not a reportable policy sale, (2) the basis of the interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of that interest in the hands of the transferor, and

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[4111] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

(3) § 1.101-1(b)(1)(ii)(B) of the proposed regulations does not apply to the transfer. The amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is, however, limited to the sum of (1) The amount that would have been excludable by the transferor, and (2) the premiums and other amounts subsequently paid by the transferee.

This limitation applies without regard to whether the interest previously has been transferred or to the nature of any prior transfer of the interest. For instance, it is irrelevant whether a prior transfer was gratuitous or for value, whether section 101(a)(2)(A) or (B) applied to a prior transfer, whether any prior transfer was a reportable policy sale, or whether the prior transfer was of the same interest or a larger interest in a life insurance contract that included the same interest. If the full amount of the proceeds would have been excludable by the transferor, as would generally be the case if the original policyholder is the transferor, § 1.101-1(b)(1)(ii)(A) of the proposed regulations will, as a practical matter, impose no limitation on the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1).

Under § 1.101-1(b)(1)(ii)(B)(1) of the proposed regulations, the limitation on the excludable amount of the proceeds described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations will not apply to an interest in a life insurance contract that is transferred for valuable consideration if (1) The transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale, and (2) the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (a (B)(1) person).

Under § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations, if a transfer of an interest in a life insurance contract to a (B)(1) person follows a transfer for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), the amount of the proceeds attributable to that interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The higher of the amount that would have been excludable by the transferor if the transfer to the (B)(1) person had not occurred or the actual value of the consideration for the transfer to the (B)(1) person paid by the (B)(1) person, and (2) the premiums and other amounts subsequently paid by the transferee. Thus, in determining the excludable amount of the proceeds attributable to an interest in a life insurance contract that is transferred to a (B)(1) person in a transfer that is not a reportable policy sale, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations is inapplicable unless the interest previously had been transferred in a reportable policy sale. Additionally, because of the alternative in the formula for computing the limitation, a (B)(1) person will not be subject to a less favorable limitation than the limitation applicable to a transferee in a carryover basis transfer eligible for the exception set forth in § 1.101-1(b)(1)(ii)(A) of the proposed regulations.

The proposed regulations provide a single rule applicable to all gratuitous transfers of interests in life insurance contracts, including reportable policy sales that are not for valuable consideration: the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and (2) the premiums and other amounts subsequently paid by the transferee. See § 1.101-1(b)(2)(i) of the

> proposed regulations. Although § 1.101-1(b)(2) of the existing regulations provides a special rule for gratuitous transfers made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, such a rule is not required by section 101(a), and the proposed regulations do not contain a special rule for these transfers because it could be subject to abuse.
>
> Section 1.101-1(b)(3) of the proposed regulations clarifies that, for purposes of § 1.101-1(b)(1) and (2) of the proposed regulations, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e). This provision is necessary to prevent an exclusion from gross income based on a double-counting of consideration paid.

Reg. § 1.101-1(b)(1)(ii), "Exceptions," explains in (A), "Exception for carryover basis transfers," when the substituted basis rule of Code § 101(a)(2)(A) causes the transfer for value rule under Code § 101(a)(2) not to apply:

> The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if each of the following requirements are satisfied. First, the transfer is not a reportable policy sale. Second, the basis of the interest, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of the interest in the hands of the transferor (see section 101(a)(2)(A)). Third, paragraph (b)(1)(ii)(B) of this section does not apply. In the case of a transfer described in this paragraph (b)(1)(ii)(A), the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. The preceding sentence applies without regard to whether the interest previously has been transferred and the nature of any prior transfer of the interest.

Thus, the substituted basis rule of Code § 101(a)(2)(A) applies when the permitted transferee rule of Code § 101(a)(2)(B), which is elaborated upon in Reg. § 1.101-1(b)(1)(ii)(B), does not apply. Reg. § 1.101-1(b)(1)(ii)(B), "Exception for transfers to certain persons," provides:

> (1) *In general*. The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if both of the following requirements are satisfied. First, the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale. Second, the interest is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)).
>
> (2) *Transfers to certain persons subsequent to a reportable policy sale*. Except as provided in paragraph (b)(1)(ii)(B)(3) of this section, if a transfer of an interest in a life insurance contract would be described in paragraph (b)(1)(ii)(B)(/) of this section, but for the fact that the interest previously was transferred for valuable consideration in a

reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), then the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of -

(i) The higher of the amount that would have been excludable by the transferor if the transfer had not occurred or the actual value of the consideration for the transfer paid by the transferee; and

(ii) The premiums and other amounts subsequently paid by the transferee with respect to the interest.

(3) *Transfers to the insured subsequent to a reportable policy sale*.

(i) Except as provided in paragraph (b)(1)(ii)(B)(3)(ii) of this section, to the extent that an interest (or portion of an interest) in a life insurance contract that was transferred for valuable consideration in a reportable policy sale subsequently is transferred to the insured for valuable consideration, the limitations described in paragraph (b)(1)(i) of this section and paragraph (b)(1)(ii)(B)(2) of this section do not apply. To the extent that fair market value is not paid by the insured for the transferred interest, the transfer of the portion of the interest with a value in excess of the consideration paid will be treated as a gift under the bargain sale rule in paragraph (b)(2)(iii) of this section.

(ii) This paragraph (b)(1)(ii)(B)(3)(ii) applies with respect to an interest described in paragraph (b)(1)(ii)(B)(3)(i) of this section (or portion of such an interest) that subsequently is transferred by the insured to any other person. If all subsequent transfers of the interest (or portion of the interest) are gratuitous transfers that are not reportable policy sales, the amount of the proceeds excluded from gross income is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to the insured's acquisition of the interest. If any subsequent transfer of the interest (or portion of the interest) is for valuable consideration or is a reportable policy sale, the amount of the policy proceeds excludable from gross income is determined in accordance with paragraph (b) of this section; if the amount that would have been excludable from gross income by the insured following the transaction described in paragraph (b)(1)(ii)(B)(3)(i) of this section if no subsequent transfer had occurred is relevant, that amount is determined under paragraph (b)(1)(ii)(B)(2) of this section. Paragraph (g)(8) (Example 8) of this section and paragraph (g)(9) (Example 9) of this section illustrate the application of this paragraph (b)(1)(ii)(B)(3)(ii).

Reg. § 1.101-1(b)(1)(ii)(B)(1) above continues the policy of the prior regulations that a transfer to a permitted transferee cleanses a prior transfer for value, but it adds in the requirement that the transfer not be a reportable policy and removes the requirement that the transfer be the final transfer before the insured's death.[4112]

[4112] Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn 4118 in part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

Reg. § 1.101-1(b)(1)(ii)(B)(3) was added in response to my comments requesting cleansing if the insured buys the policy after a reportable policy sale. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4113]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[4114] shed some light on this rule (other than the cleansing aspects, which are discussed later:

(10) *Example 10*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to Corporation X in exchange for stock. Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. Corporation X conducts an active trade or business that it wholly owns, and A materially participates in that active trade or business as an employee of Corporation X. Corporation X receives the proceeds of $100,000 on A's death. A's contribution of the policy to Corporation X is not a reportable policy sale because Corporation X has a substantial business relationship with A under paragraph (d)(2)(i) of this section. Although Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy, paragraph (b)(1)(ii)(A) of this section does not apply because the insured, A, is a shareholder of Corporation X and the other requirements under paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(/) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.

(11) *Example 11*. The facts are the same as in Example 10 in paragraph (g)(10) of this section, except that Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization at a time when A is still employed by Corporation X, but is no longer a shareholder of Corporation X. Corporation Y's basis in the policy is determinable in whole or in part by reference to Corporation X's basis in the policy, and Corporation Y carries on the trade or business acquired from Corporation X. Corporation Y receives the proceeds of $100,000 on A's death. The transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A under paragraph (d)(2)(ii) of this section. The amount of the proceeds that Corporation Y may exclude from gross income is limited under paragraph (b)(1)(ii)(A) of this section to the sum of the amount that would have been excludable by Corporation X had the transfer to Corporation Y not occurred, plus any premiums and other amounts paid by Corporation Y with respect to the policy subsequent to the transfer. Accordingly, because Corporation X's exclusion is not limited by paragraph (b) of this section, as described in Example 10 in paragraph (g)(10) of this section, Corporation Y's exclusion is not limited by paragraph (b) of this section.

(12) *Example 12*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After

[4113] Especially text accompanying fn 4122.

[4114] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

the acquisition, A owns less than 20% of the outstanding stock of Corporation W and owns stock possessing less than 20 % of the total combined voting power of all stock of Corporation W and is therefore not a key person with respect to Corporation W under section 264(e)(3). Corporation W's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. However, no substantial family, business, or financial relationship exists between A and Corporation W, so A's contribution of the policy to Corporation W is a reportable policy sale. Corporation W receives the proceeds of $100,000 on A's death. Under paragraph (b)(1)(i) of this section, the amount of the proceeds Corporation W may exclude from gross income is limited to the actual value of the stock exchanged for the policy, plus any premiums and other amounts paid by Corporation W with respect to the policy subsequent to the transfer. The exceptions in paragraph (b)(1)(ii) of this section do not apply because the transfer to Corporation W is a reportable policy sale.

Example (10) meets each element of the 3-prong test of Reg. § 1.101-1(b)(1)(ii). Example (11) meets the substituted basis and not-a-reportable-sale elements but not the qualified transferee element. However, Example (11) concludes that, because the transferor would have excluded the proceeds from gross income, the substituted-basis transferee may also do so. Thus, Reg. § 1.101-1(b)(1) is essentially imprinting on to the substituted basis rule of Code § 101(a)(2)(A) the idea that a policy's taint under the transfer-for-value rule continues when the policy is transferred in a substituted basis transaction without being cleansed. Conventional wisdom had been that a transfer to the insured would cleanse the taint. However, Reg. § 1.101-1 seems to suggest limitations on which transfers to the insured would cleanse the taint; see part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

Example (12) points out that a substituted basis transfer that is a reportable policy sale is subject to the transfer-for-value rules, which is consistent with Code § 101(a)(3).

II.Q.4.b.ii.(e). Cleansing by Transfer Back to Insured or Permitted Transferee

For a sale that is ***not*** a reportable policy sale, Examples (1), (2) and (3) in Reg. § 1.101-1(g)(1), (2), and (3)[4115] describe how to cleanse a policy:

(1) *Example 1*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy to B, A's child, for $6,000, its fair market value. B is not a partner in a partnership in which A is a partner. B receives the proceeds of $100,000 upon the death of A. Because the transfer to B was for valuable consideration, and none of the exceptions in paragraph (b)(1)(ii) of this section applies, the amount of the proceeds B may exclude from B's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by B with respect to the policy subsequent to the transfer.

(2) *Example 2*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of $100,000 on A's death. Because the transfer from B to A is

[4115] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

a gratuitous transfer to the insured, and the preceding transfer from A to B was not a reportable policy sale, the amount of the proceeds A's estate may exclude from gross income under this section is not limited by paragraph (b)(2)(i) of this section.

(3) *Example 3*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B sells the policy back to A for its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from A to B is not a reportable policy sale because the acquirer B has a substantial family relationship with the insured, A. The transfer from B to A also is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Accordingly, paragraph (b)(1)(ii)(B)(*l*) of this section applies to the transfer to A, and the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

Before discussing cleansing, let's discuss Example (1). If A had given the policy to B, then the gift would have qualified for the substituted basis exception to the transfer for value rule. If A had sold the policy to an irrevocable grantor trust that A had previously established for B, the sale would have been disregarded and the rule would not have applied.[4116]

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[4117]

Example (3) applies the exception for a transfer for valuable consideration to a permitted transferee in Reg. § 1.101-1(b)(1)(ii)(B)(1).[4118] Unlike Example (2), it was a transfer for valuable consideration, so it also had to avoid being a reportable policy sale.

For a sale that ***is*** a reportable policy sale, the Examples in Reg. § 1.101-1(g)(4), (5), and (6)[4119] in the proposed regulations asserted that no transfer back to the insured will cleanse the policy from the transfer for value rules, but the final regulations allow a fair market value sale to the insured to cleanse the policy:

(4) *Example 4*. A is the initial policyholder of a $100,000 insurance policy on A's life. A transfers the policy for $6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A. The transfer from A to C is a reportable policy sale. C receives the proceeds of $100,000 on A's death. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer.

4116 See Rev. Rul. 2007-13, reproduced in fn 4074 in part II.Q.4.b.i Transfer for Value Rule Generally.

4117 Fn 4123 reproduces the relevant part of . § 1.101-1(b)(2)(i), and Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4087 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

4118 See text accompanying and preceding fn 4112 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.

4119 Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

(5) *Example 5*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy to D, a partner of A who co-owns real property with A, for $8,000, the policy's fair market value. D receives the proceeds of $100,000 on A's death. The transfer from C to D is not a reportable policy sale because the acquirer D has a substantial financial relationship with the insured, A. However, because that transfer follows a reportable policy sale (the transfer from A to C), the amount of the proceeds that D may exclude from gross income under this section is limited by paragraph (b)(1)(ii)(B)(2) of this section to the sum of--

(i) The higher of the amount C could have excluded had the transfer to D not occurred ($6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C, as described in Example 4 in paragraph (g)(4) of this section) or the actual value of the consideration for that transfer paid by D ($8,000); and

(ii) Any premiums and other amounts paid by D with respect to the policy subsequent to the transfer to D.

(6) *Example 6*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy back to A for $8,000, its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Although the transfer follows a reportable policy sale (the initial transfer from A to C), A's estate may exclude all of the policy proceeds from gross income because paragraph (b)(1)(ii)(B)(3)(i) of this section applies and, therefore, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

Reg. § 1.101-1(g)(7), Example (7)[4120] applies the bargain sale rule to Example (6):

(7) *Example 7*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that C transfers the policy back to A for $4,000, rather than its fair market value of $8,000. A's estate receives the proceeds of $100,000 on A's death. Because A did not pay fair market value for the policy, the transfer is bifurcated and treated as a bargain sale under paragraph (b)(2)(iii) of this section. A therefore is treated as having purchased 50% of the policy interest for valuable consideration equal to fair market value and as having received 50% of the policy interest in a gratuitous transfer. The transfer from C to A is not a reportable policy sale because the acquirer, A, has a substantial family relationship with the insured, A, but the transfer from C to A follows a reportable policy sale (the transfer from A to C).

(i) *Treatment of policy interest purchased by A*. A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration ($50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section,

[4120] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

the amount of the proceeds that may be excluded from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

(ii) *Treatment of policy interest gratuitously transferred to A*. The amount of the policy proceeds related to the 50% policy interest transferred gratuitously that A's estate may exclude from income is limited under paragraph (b)(2)(i) of this section to the sum of the amount C could have excluded with respect to 50% of the policy had the transfer back to A not occurred (that is, 50% of the $6,000 that C paid A for the policy, plus 50% of any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C), plus 50% of any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

Additional cleansing examples are in Reg. § 1.101-1(g)(8) and (9), Examples (8) and (9)[4121]:

(8) *Example 8*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that, before A's death, A gratuitously transfers 50% of the policy interest to B, A's child, and sells 50% of the policy interest for its fair market value to an individual, E, who does not have a substantial family, business, or financial relationship with A. B and E each receive $50,000 of the proceeds on A's death. Paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that B and E may exclude from gross income because the policy interests transferred to B and E were first transferred for valuable consideration in a reportable policy sale (the transfer by A to C) and then transferred to the insured, A, for fair market value.

(i) *Treatment of policy interest transferred to B*. With respect to the portion of the policy interest transferred to B, because the transfer to B was the only transfer subsequent to the transfer to A and the transfer to B was gratuitous and not a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by B is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to A's acquisition of the interest. Under paragraph (b)(2)(i) of this section, the amount of the proceeds B may exclude is limited to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B. As described in Example 6 in paragraph (g)(6) of this section, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section. Accordingly, the amount of the proceeds that B may exclude from gross income is not limited by paragraph (b) of this section.

(ii) *Treatment of policy interest transferred to E*. With respect to the portion of the policy interest transferred to E, because the transfer to E was not gratuitous and was a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the

[4121] Reg. § 1.101-1(g), "Examples," begins with:
The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

amount of the policy proceeds excludable from gross income by E is determined in accordance with paragraph (b) of this section. Accordingly, because the transfer to E was for valuable consideration, the amount excludable from gross income by E is limited by paragraph (b)(1)(i) of this section unless an exception in paragraph (b)(1)(ii) of this section applies. Because the transfer from A to E is a reportable policy sale, none of the exceptions in paragraph (b)(1)(ii) of this section apply. Therefore, the amount of the proceeds E may exclude from gross income under this section is limited by paragraph (b)(1)(i) of this section to the sum of the consideration paid by E and the premiums and other amounts paid by E with respect to the policy subsequent to the transfer to E.

(9) *Example 9*. The facts are the same as in Example 8 in paragraph (g)(8) of this section, except that, before A's death, B transfers B's policy interest to Partnership F, whose partners are A and other family members of A, in exchange for a partnership interest in Partnership F. Partnership F receives $50,000 of the proceeds on A's death. With respect to the policy interest transferred to Partnership F, paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that Partnership F may exclude from gross income for the reasons described in Example 8 in paragraph (g)(8) of this section.

(i) *Treatment of policy interest transferred to Partnership F*. The transfer to Partnership F was not a reportable policy sale. However, because the transfer to Partnership F was not gratuitous, the amount of the policy proceeds excludable from gross income by Partnership F is determined in accordance with paragraph (b) of this section as if the amount that would have been excludable from gross income by A following the transfer to A, if no subsequent transfer had occurred, was determined under paragraph (b)(1)(ii)(B)(2) of this section. Because B's transfer to Partnership F was a transfer for valuable consideration to a partnership in which the insured is a partner that was preceded by a reportable policy sale (the transfer to C), the amount of the proceeds Partnership F may exclude from gross income under this section is limited under paragraph (b)(1)(ii)(B)(2) of this section to the higher of the amount that would have been excludable by B if the transfer to Partnership F had not occurred or the actual value of the consideration for the policy paid by Partnership F, plus any premiums and other amounts paid by Partnership F with respect to the policy subsequent to the transfer to Partnership F.

(ii) *Amount that B could have excluded*. Because the transfer from A to B was a gratuitous transfer, the amount of the proceeds B could have excluded from gross income under this section if the transfer to Partnership F had not occurred is limited under paragraph (b)(2)(i) of this section to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B.

(iii) *Amount that A could have excluded*. As described in paragraph (g)(9)(i) of this section, the amount of the proceeds A could have excluded under this section if the transfer to B had not occurred must be determined under paragraph (b)(1)(ii)(B)(2) of this section in accordance with paragraph (b)(1)(ii)(B)(3)(ii) of this section. Under paragraph (b)(1)(ii)(B)(2) of this section, the amount that would have been excludable by A is limited to the higher of the amount that would have been excludable by C if the transfer to A had not occurred ($6,000 plus premiums and other amounts subsequently paid by C) or the actual value of the consideration for the policy paid by A ($8,000), plus any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

These Examples helpfully illustrate that reportable policy sale can be completely cleansed through a sale to the insured for fair market value, and a subsequent transferee may (if appropriate) inherit the policy's cleansed status.[4122] A bargain sale is broken into its separate components of a sale plus a gratuitous transfer. A gratuitous transfer back to the insured does not cleanse the policy after a reportable policy sale. Furthermore, Reg. § 1.101-1(b)(2) also provides cleansing: "if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income."[4123] And that cleansing can apply to subsequent transferees, when appropriate. I am delighted that, in response my comments, the final regulations provide both of these cleansing opportunities.

Contrast this to what was in effect before the reportable policy sale rules were enacted, Reg. § 1.101-1(b)(3), which had provided:

> In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration -
>
> (i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—
>
> (a) The actual value of the consideration paid by him, and
>
> (b) The premiums and other amounts subsequently paid by him;
>
> (ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;
>
> (iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—
>
> (a) The amount which would have been excludable by his transferor if no such transfer had taken place, and
>
> (b) Any premiums and other amounts subsequently paid by the final transferee himself.

[4122] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn 4113.
[4123] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4087 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

Thus, under prior regulations, cleansing applied only to a transfer to the insured for valuable consideration and then only if the insured or a permitted transferee was the final transferee. The prior regulations were much more narrow than what the 2019 regulations adopted.

II.Q.4.b.ii.(f). Reporting Requirements for Reportable Policy Sales

See "About Form 1099-LS, Reportable Life Insurance Sale," at https://www.irs.gov/forms-pubs/about-form-1099-ls.

Code § 6050Y, "Returns relating to certain life insurance contract transactions," starts with subsection (a), "Requirements of reporting of certain payments":

(1) *In general*. Every person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of such person,

(B) the name, address, and TIN of each recipient of payment in the reportable policy sale,

(C) the date of such sale,

(D) the name of the issuer of the life insurance contract sold and the policy number of such contract, and

(E) the amount of each payment.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to such person, except that in the case of an issuer of a life insurance contract, such statement is not required to include the information specified in paragraph (1)(E).

Code § 6050Y(b), "Requirement of reporting of seller's basis in life insurance contracts," provides:

(1) *In general*. Upon receipt of the statement required under subsection (a)(2) or upon notice of a transfer of a life insurance contract to a foreign person, each issuer of a life insurance contract shall make a return (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the seller who transfers any interest in such contract in such sale,

(B) the investment in the contract (as defined in section 72(e)(6)) with respect to such seller, and

(C) the policy number of such contract.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each seller whose name is required to be set forth in such return.

Code § 6050Y(c), "Requirement of reporting with respect to reportable death benefits," provides:

(1) In general. Every person who makes a payment of reportable death benefits during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the person making such payment,

(B) the name, address, and TIN of each recipient of such payment,

(C) the date of each such payment,

(D) the gross amount of each such payment, and

(E) such person's estimate of the investment in the contract (as defined in section 72(e)(6)) with respect to the buyer.

(2) Statement to be furnished to persons with respect to whom information is required. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each recipient of payment whose name is required to be set forth in such return.

Code § 6050Y(d), "Definitions," provides that, for purposes of Code § 6050Y:

(1) *Payment*. The term "payment" means, with respect to any reportable policy sale, the amount of cash and the fair market value of any consideration transferred in the sale.

(2) *Reportable policy sale*. The term "reportable policy sale" has the meaning given such term in section 101(a)(3)(B).

(3) *Issuer*. The term “issuer” means any life insurance company that bears the risk with respect to a life insurance contract on the date any return or statement is required to be made under this section.

(4) *Reportable death benefits*. The term “reportable death benefits” means amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For details on the definition of “reportable policy sale” in Code § 101(a)(3)(B), see part II.Q.4.b.ii.(c) “Reportable Policy Sale”.

Part 1.A.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), “Applicability Date for Section 6050Y Regulations,” explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.
>
> One commenter recommended that reporting obligations under section 6050Y (as well as application of the rules under section 101 relating to section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register. Informal comments also were received requesting transition relief (such as delayed reporting) or permanent relief with respect to the reporting obligations under section 6050Y for reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before January 1, 2019 (such as waiving the reporting obligations for this period). One commenter requested that at least an additional 30 days be added to the 90-day relief period provided in § 1.6050Y-1(b)(2) and (3) of the proposed regulations for filing returns and furnishing statements required under section 6050Y(b) and (c) and § 1.6050Y-3 and 1.6050Y-4 of the proposed regulations, to give issuers at least 60 days to complete their reporting after the 60-day extension period provided to acquirers of an interest in a life insurance contract under § 1.6050Y-1(b)(1) of the proposed regulations. The commenter asserted that issuers require significantly more time than the 30 days effectively provided to complete Forms 1099-SB, “Seller’s Investment in Life Insurance Contract,” and 1099-R “Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.”, and to add new forms (such as Form 1099-SB) to their systems. The commenter stated that issuers must identify policies that are subject to reporting once the Forms 1099-LS, “Reportable Life Insurance Sale,” are received as well as enhance systems to track these policies over their life and transmit data between various systems in order to accurately report under sections 6050Y(b) and (c).
>
> In response to these comments, and to give acquirers and issuers ample time to develop and implement reporting systems, the final regulations provide that the rules in §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. As a result, no reporting is required under section 6050Y for reportable policy sales made and reportable death benefits paid after December 31, 2017, and before January 1, 2019.

> Section 1.6050Y-1(a)(12) of the final regulations defines “reportable death benefits” as “amounts paid by reason of the death of the insured under a life insurance contract that are attributable to an interest in the contract that was transferred in a reportable policy sale.” Accordingly, because the definition of “reportable policy sale” under § 1.6050Y-1(a)(14) of the final regulations applies only to transfers of interests in life insurance contracts made after December 31, 2018, death benefits are “reportable death benefits” under § 1.6050Y-1(a)(12) of the final regulations and are subject to the reporting requirements of § 1.6050Y-4 of the final regulations only if the death benefits are paid by reason of the death of the insured under a life insurance contract transferred after December 31, 2018, in a reportable policy sale.
>
> The final regulations also provide transition relief as set forth in the proposed regulations with two modifications. First, the transition relief applies with respect to reportable policy sales made and reportable death benefits paid after December 31, 2018, and on or before October 31, 2019. Second, as requested by one of the commenters, § 1.6050Y-1(b)(3), (4), and (5) of the final regulations provide issuers with at least 120 days after the final regulations are published in the Federal Register to file returns and furnish statements under section 6050Y(b) and (c) and §§ 1.6050Y-3 and 1.6050Y-4 of the final regulations. These features of the final regulations are intended to give acquirers and issuers ample time to develop and implement reporting systems.
>
> Noting that 250 or more information returns of a single taxpayer must be filed electronically, one commenter requested waivers from electronic filing for 2018 and 2019 issuer reporting under section 6050Y(b) and (c). The Treasury Department and the IRS have determined not to provide the requested waiver in the final regulations under section 6050Y because procedures already exist for any person required to file 250 or more returns during the calendar year to request a waiver from the requirement to file electronically by showing hardship. See § 301.6011-2(c).

Part 7 of the preamble to the final regulations, T.D. 9879 (10/31/2019), “Comments and Changes Relating to Sec. 1.6050Y-1 of the Proposed Regulations,” explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.

I have not reproduced the rest of the preamble explaining various changes to these regulations.

Reg. § 1.6050Y-2, “Information reporting by acquirers for reportable policy sale payments,” provides:

> (a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, every person that is an acquirer in a reportable policy sale during any calendar year must file a separate information return with the Internal Revenue Service (IRS) in the form and manner as required by the IRS for each reportable policy sale payment recipient, including any seller that is a reportable policy sale payment recipient. Each return must include the following information with respect to the seller or other reportable policy sale payment recipient to which the return relates:

(1) The name, address, and taxpayer identification number (TIN) of the acquirer;

(2) The name, address, and TIN of the seller or other reportable policy sale payment recipient to which the return relates;

(3) The date of the reportable policy sale;

(4) The name of the 6050Y(a) issuer of the life insurance contract acquired and the policy number of the life insurance contract;

(5) The aggregate amount of reportable policy sale payments made, or to be made, to the seller or other reportable policy sale payment recipient to which the return relates with respect to the reportable policy sale; and

(6) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. The information reporting requirement of paragraph (a) of this section applies to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract. In either case, an acquirer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that acquirer is timely reported on behalf of that acquirer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(c) *Time and place for filing*. Returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Statements to reportable policy sale payment recipients*.

(i) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment recipient must furnish in the form and manner prescribed by the IRS to the reportable policy sale payment recipient whose name is set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to the reportable policy sale payment recipient and the name, address, and phone number of the information contact of the person furnishing the written statement. The contact information of the person furnishing the written statement must provide direct access to a person that can answer questions about the statement. The statement is not required to include information with respect to any other reportable policy sale payment recipient in the reportable policy sale or information about reportable policy sale payments to any other reportable policy sale payment recipient.

(ii) *Time for furnishing statement*. Each statement required by paragraph (d)(1)(i) of this section to be furnished to any reportable policy sale payment recipient must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(2) for transition rules.

(2) *Statements to 6050Y(a) issuers*.

(i) *Requirement of furnishing RPSS*.

(A) *In general*. Except as provided in paragraph (d)(2)(i)(B) of this section, every person required to file a return under paragraph (a) of this section must furnish in the form and manner prescribed by the IRS to the 6050Y(a) issuer whose name is required to be set forth in the return an RPSS with respect to each reportable policy sale payment recipient that is also a seller. Each RPSS must show the information required by paragraph (a) of this section with respect to the seller named therein, except that the RPSS is not required to set forth the amount of any reportable policy sale payment. Each RPSS must also show the name, address, and phone number of the information contact of the person furnishing the RPSS. This contact information must provide direct access to a person that can answer questions about the RPSS.

(B) *Exception from reporting*. An RPSS is not required to be furnished to the 6050Y(a) issuer by an acquirer acquiring an interest in a life insurance contract in an indirect acquisition.

(ii) *Time for furnishing RPSS*. Except as provided in this paragraph (d)(2)(ii), each RPSS required by paragraph (d)(2)(i) of this section to be furnished to a 6050Y(a) issuer must be furnished by the later of 20 calendar days after the reportable policy sale, or 5 calendar days after the end of the applicable state law rescission period. However, if the later date is after January 15 of the year following the calendar year in which the reportable policy sale occurred, the RPSS must be furnished by January 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(1) for transition rules.

(3) *Unified reporting*. The information reporting requirements of paragraphs (d)(1)(i) and (d)(2)(i) of this section apply to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract, as described in paragraph (b) of this section. In either case, an acquirer's obligation to furnish statements is deemed satisfied if the information required by paragraphs (d)(1)(i) and (d)(2)(i) of this section with respect to that acquirer is timely reported on behalf of that acquirer consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(a)(1) and this section with respect to a reportable policy sale must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(a)(2) and this section with respect to the reportable policy sale must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale.

(f) *Exceptions to requirement to file*.

(1) An acquirer that is a foreign person is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale unless -

(i) The life insurance contract (or interest therein) transferred in the sale is on the life of an insured who is a United States person at the time of the sale; or

(ii) The sale is subject to the laws of one or more States of the United States that pertain to acquisitions or sales of life insurance contracts (or interests therein).

(2) An acquirer is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment to a reportable policy sale payment recipient other than the seller if the reportable policy sale payment is reported by the acquirer under section 6041 or 6041A.

(3) An acquirer is not required to file an information return under paragraph (a) of this section with respect to the issuance of a life insurance contract in an exchange pursuant to section 1035. However, the acquirer is required to furnish the 6050Y(a) issuer with the statement required under paragraph (d)(2) of this section as if the acquirer were required to file an information return under paragraph (a) of this section.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(a)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(a)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-6, "Information reporting by 6050Y(b) issuers for reportable policy sales and transfers of life insurance contracts to foreign persons," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, each 6050Y(b) issuer that receives an RPSS or any notice of a transfer to a foreign person must file an information return with the Internal Revenue Service (IRS) with respect to each seller in the form and manner prescribed by the IRS. The return must include the following information with respect to the seller:

(1) The name, address, and taxpayer identification number (TIN) of the seller;

(2) The investment in the contract with respect to the seller;

(3) The amount the seller would have received if the seller had surrendered the life insurance contract on the date of the reportable policy sale or the transfer of the contract to a foreign person, or if the date of the transfer to a foreign person is not known to the 6050Y(b) issuer, the date the 6050Y(b) issuer received notice of the transfer; and

(4) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (a) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(c) *Time and place for filing*. Except as provided in this paragraph (c), returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale or the transfer to a foreign person occurred. If the 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, returns required to be made under paragraph (a) of this section must be filed by the later of February 28 (March 31 if filed electronically) of the calendar year following the year in which the transfer occurred or thirty days after the date notice is received. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every 6050Y(b) issuer filing a return required by paragraph (a) of this section must furnish to each seller that is a reportable policy sale payment recipient or makes a transfer to a foreign person and whose name is required to be set forth in the return a written statement showing the information required by paragraph (a) of this section with respect to that seller and the name, address, and phone number of the information contact of the person filing the return. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Except as provided in this paragraph (d)(2), each statement required by paragraph (d)(1) of this section to be furnished to any seller must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale or transfer to a foreign person occurred. If a 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, each statement required to be made under paragraph (d) of this section must be

furnished by the date thirty days after the date notice is received. However, see § 1.6050Y-1(b)(3) for transition rules.

(3) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (d)(1) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (d)(1) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale or transfer of an insurance contract to a foreign person*. Any 6050Y(b) issuer that has filed a return required by section 6050Y(b)(1) and this section with respect to a reportable policy sale or transfer of an insurance contract to a foreign person must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person. Any 6050Y(b) issuer that has furnished a written statement under section 6050Y(b)(2) and this section with respect to the reportable policy sale or transfer of the insurance contract to a foreign person must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person.

(f) *Exceptions to requirement to file*. A 6050Y(b) issuer is not required to file an information return under paragraph (a) of this section if paragraph (f)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (f)(1), the 6050Y(b) issuer obtains documentation upon which it may rely to treat a seller of a life insurance contract or interest therein as a foreign beneficial owner in accordance with § 1.1441-1(e)(1)(ii), applying in such case the provisions of § 1.1441-1 by substituting the term "6050Y(b) issuer" for the term "withholding agent" and without regard to the fact that that these provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A 6050Y(b) issuer may also obtain from a seller that is a partnership or trust, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the proceeds of the sale is a United States person. In such a case, the issuer may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (f)(1) provided that the seller does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the proceeds of the sale. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (f)(1). Additionally, for certifying its status as a foreign beneficial owner (as applicable) for purposes of this paragraph (f)(1), a seller that is required to report any of the income from the sale as effectively connected with the conduct of a trade or business in the United States under section 864(b) is required to provide to the 6050Y(b) issuer a Form W-8ECI, Certificate of Foreign Person's Claim that Income is Effectively Connected with the Conduct of a Trade or Business in the United States. If a 6050Y(b) issuer obtains a Form W-8ECI from a seller with respect to the sale or has reason to know that income from the sale is effectively connected with the conduct of a trade or

business in the United States under section 864(b), the exception to reporting described in this paragraph (f)(1) does not apply.

(2) The 6050Y(b) issuer receives notice of a transfer to a foreign person, but does not receive an RPSS with respect to the transfer, provided that, at the time the notice is received -

(i) The 6050Y(b) issuer is not a United States person;

(ii) The life insurance contract (or interest therein) transferred is not on the life of a United States person; and

(iii) The 6050Y(b) issuer has not classified the seller as a United States person in its books and records.

(3) The RPSS received by the 6050Y(b) issuer is with respect to the 6050Y(b) issuer's issuance of a life insurance contract to a policyholder in an exchange pursuant to section 1035.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(b)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(b)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-7, "Information reporting by payors for reportable death benefits," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (e) of this section, every person that is a payor of reportable death benefits during any calendar year must file a separate information return for such calendar year with the Internal Revenue Service (IRS) for each reportable death benefits payment recipient in the form and manner prescribed by the IRS. The return must include the following information with respect to the reportable death benefits payment recipient to which the return relates:

(1) The name, address, and taxpayer identification number (TIN) of the payor;

(2) The name, address, and TIN of the reportable death benefits payment recipient;

(3) The date of the payment;

(4) The gross amount of reportable death benefits paid to the reportable death benefits payment recipient during the taxable year;

(5) The payor's estimate of investment in the contract with respect to the buyer, limited to the payor's estimate of the buyer's investment in the contract with respect to the interest for which the reportable death benefits payment recipient was paid; and

(6) Any other information that is required by the form or its instructions.

(b) *Time and place for filing*. Returns required to be made under this section must be filed with the Internal Revenue Service Center designated in the instructions for the form on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(5) for transition rules.

(c) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section must furnish to each reportable death benefits payment recipient whose name is required to be set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to that reportable death benefits payment recipient and the name, address, and phone number of the information contact of the payor. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Each statement required by paragraph (c)(1) of this section to be furnished to any reportable death benefits payment recipient must be furnished on or before January 31 of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(4) for transition rules.

(d) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(c) and this section with respect to a payment of reportable death benefits must file a corrected return within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(c)(2) and this section with respect to a payment of reportable death benefits must furnish the recipient of that statement with a corrected statement within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale.

(e) *Exceptions to requirement to file*. A payor is not required to file an information return under paragraph (a) of this section with respect to a payment of reportable death benefits if paragraph (e)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (e)(1), the payor obtains documentation in accordance with § 1.1441-1(e)(1)(ii) upon which it may rely to treat the reportable death benefits payment recipient as a foreign beneficial owner of the reportable death benefits, applying in such case the provisions of § 1.1441-1 by substituting the term "payor" for the term "withholding agent" and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A payor may also obtain from a

partnership or trust that is a reportable death benefits recipient, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the reportable death benefits payment is a United States person. In such a case, a payor may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (e)(1) provided that the payor does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the reportable death benefits payment. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (e)(1). Other due diligence or reporting requirements may, however, apply to a payor that relies on the exception set forth in this paragraph (e)(1). See § 1.1441-5(c) and (e) (determination of payees of foreign partnerships and certain foreign trusts for amounts subject to withholding under § 1.1441-2(a)) and § 1.1461-1(b) and (c) (amounts subject to reporting for chapter 3 purposes).

(2) The buyer obtained the life insurance contract (or interest therein) under which reportable death benefits are paid in a reportable policy sale to which the exception to reporting described in § 1.6050Y-3(f)(2) applies.

(3) The payor never received, and has no knowledge of any issuer having received, an RPSS with respect to the interest in a life insurance contract with respect to which the reportable death benefits are paid.

(f) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(c)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(c)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

II.Q.4.b.ii.(g). Transfer of Interest in an Entity Holding Life Insurance

Under pre-2018 law, a transfer of an interest in an entity did not constitute a transfer of the entity's life insurance under the transfer for value rule. Letter Ruling 9410039, involving a general partnership, held:

> … the admittance of new partners to Taxpayer and/or the withdrawal of partners from Taxpayer will not result in a transfer for valuable consideration under section 101(a)(2) of the life insurance contract on Managing Director, provided there is no termination of the partnership under section 708(b). We express no opinion about the application of

section 101(a)(2) in the event that there is a termination of the partnership under section 708(b).[4124]

For an LLC taxed as a partnership, Letter Ruling 200826009 similarly ruled:

> … the sale or exchange of membership interests in X either by N or any of the Investors will not result in a transfer for a "valuable consideration" under § 101(a)(2), provided there is no termination of the partnership under § 708(b)(1)(B).[4125]

2017 tax reform did not change the language that what triggers the transfer for value rules is "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4126] Code § 101(a)(3)(A) added that the permitted transfer and permitted transferee exceptions to the transfer for value rule "shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale." Code § 101(a)(3)(B) defines a "reportable policy sale" as "the acquisition of an interest in a life insurance contract, directly or indirectly," if the acquirer does not have a required connection to the insured.

As described in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract, Reg. § 1.101-1(e)(1), "Definition,"[4127] an "interest" refers to taking "title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes," as well as holding "an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy" as described in Reg. § 20.2042-1(c)(2) (incidents of ownership).

Applying the above definition of an "interest" in a contract, it appears that for purposes of testing whether a transfer for value has occurred that may affect the exclusion of a death benefit from income, direct ownership of a policy (in whole or in part) must be subjected to a "transfer for a valuable consideration."[4128] Therefore, the conclusion of Letter Rulings 9410039 and 200826009 - that a transfer of a partnership interest does not constitute a deemed transfer of the partnership's insurance policies - would seem to continue to apply. Presumably the same analysis would apply to the transfer of an interest in any other type of entity.

Through this lens, let's consider that a transfer of an interest in an entity may cause the acquirer to have an "indirect acquisition" that constitutes a reportable policy sale.[4129] Although such a transfer does not appear to trigger the transfer for value rule's income taxation of death benefits, it may trigger reporting requirements, given that the rules in part II.Q.4.b.ii.(f) Reporting

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4124 [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

4125 [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

4126 Code § 101(a)(2).

4127 Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn 4090.

4128 For a discussion of legislative history supporting this idea, see fn 4083 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

4129 Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4092 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4099 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

Requirements for Reportable Policy Sales refer to the definition in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

If the required connection with the insured exists, one does not need to worry about an "indirect acquisition." Also, the "indirect acquisition" rule does not apply if:[4130]

> A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

So, if the entity acquired each life insurance contract before January 1, 2019, one does not need worry about the transfer of any interest in the entity (but, for policies issued after August 17, 2006, see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance). One also need not worry when dealing with an interest of no more than 5%, if the entity does not hold mainly life insurance contracts.[4131] Otherwise, one may need to file Form 1099-LS for each policy, to qualify for the exception for a reportable policy sale reported in compliance with Code § 6050Y(a) and Reg. § 1.6050Y-2.

Although I feel comfortable taking the position that the rule regarding indirect acquisitions does not cause the transfer of an interest in a business entity to be a transfer for value, the IRS might assert that such a position makes the reportable policy sale rule toothless for income tax purposes, because all one needs to do to protect a life insurance contract from the income tax consequences is to put the life insurance in a partnership wrapper. Thus, the IRS' might argue that an "indirect acquisition" constitutes a "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4132]

Therefore, when in doubt regarding whether the transfer of an interest in a business entity might constitute an "indirect acquisition," one should consider reporting on Form 1099-LS any policy where the requisite relationship with the insured might not exist, to avoid any argument by the IRS that the policy's death benefit might be subjected to income tax.

II.Q.4.b.iii. Basis in Purchased Life Insurance Contract

Rev. Rul. 2009-13 took the position that the basis of a policy that is sold to a person other than the issuer is not equal to the premiums paid.[4133] Effective for transactions entered into after August 25, 2009 (coinciding with the effective date of the IRS' position), section 13521 of the 2017 tax reform act reversed the IRS' position,[4134] adding Code § 1016(a)(1)(B), which provides:

4130 Reg. § 1.101-1(c)(2)(iii)(A), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4099 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

4131 Reg. § 1.101-1(c)(2)(iii)(B), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4099 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

4132 Code § 101(a)(2).

4133 See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.

4134 The Senate report stated:

> The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

> Proper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.

Rev. Rul. 2020-5 modifies Rev. Ruls. 2009-13 and 2009-14 to effectuate Code § 1016(a)(1)(B).[4135]

For basis step-up when an owner who is not the insured dies and for an analysis of "investment in the contract" (which governs distributions from a policy) generally, see part II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies.

II.Q.4.c. Income Tax Issues in Transferring Life Insurance Used in Cross-Purchase Agreements

When transferring policies as buy-sell needs and the identities of owners change:

1. Generally, income tax applies when buying, selling, or swapping policies. Generally, Code § 1035 nonrecognition of gain when swapping policies applies only when the policies

[4135] For details on Rev. Rul. 2020-5, see text accompanying fn 4144.

have the same insureds.[4136] A taxpayer may roll over part of a policy into another policy.[4137] A life insurance contract may be swapped into another life insurance, endowment, annuity, or qualified long-term care insurance contract.[4138] If one insured in a second-to-die policy has

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[4136] Rev. Rul. 90-109 examined a contract that allowed the insured to change (highlighting added):

> A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one. *Cf.* Rev. Rul. 69-135, 1969-1 C.B. 198 (recognition of realized gain or loss under former section 1002 where bonds of one corporation are converted into stock of another corporation pursuant to an option contained in the bonds). See also Rev. Rul. 79-155, 1979-1 C.B. 153 (addition of new parent as obligor is a change which, together with other changes, constitutes a material change for purposes of section 1001).
>
> In the present situation, X exercised an option in its key person insurance policy that permitted it to change the insured from A, the original insured under the policy, to B, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract. Thus, X's exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.
>
> Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had X actually assigned a life insurance policy on A to the insurance company as consideration for a new life insurance policy on B, any gain realized on the exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. X cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if X insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

It held:

> The exercise of an option in an insurance policy to change the insured constitutes a sale or other disposition under section 1001 of the Code, and this disposition does not qualify as a tax-free exchange of insurance policies under section 1035.

[4137] Notice 2011-68, § 2.05 states:

> In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a "partial exchange." See also Rev. Rul. 2003-76, 2003-2 C.B. 355 (direct transfer of a portion of an annuity contract for a new annuity contract treated as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

[4138] Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):

> .04. Section 844(b) of the PPA expanded the categories of exchanges that are treated as tax-free under § 1035 to include certain exchanges that involve a qualified long-term care insurance contract. Accordingly, § 1035 now applies to the exchange of a life insurance contract for another life insurance, endowment, annuity, or qualified long-term care insurance contract; an endowment contract for another endowment, annuity, or qualified long-term care insurance contract; an annuity contract for another annuity or qualified long-term care insurance contract; or a qualified long-term care insurance contract for another qualified long-term care insurance contract. The PPA also amended § 1035(b)(2) and (3) to provide that, for purposes of § 1035, a contract does not fail to

died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured.[4139] However, Code § 1035 does not apply to changing from having two insureds under a second-to-die policy to one insured under a policy or from one insured under a policy to two insureds under a second-to-die policy.[4140]

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be treated as a life insurance contract or an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on the contract.

.05. Just as the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a second annuity contract may be treated as a tax-free exchange under § 1035, the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a qualified long-term care insurance contract may be treated as a tax-free exchange, provided the requirements of § 1035 are otherwise met. See, *e.g.*, Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (setting forth conditions under which such a transfer will be treated as a tax-free exchange under § 1035); but see, Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035).

.06. Although § 7702B(b)(1)(D) and (E) limit the extent to which a qualified long-term care insurance contract may have a cash value or premium refund feature, § 7702B(b)(2)(C) permits the refund of premiums in the event of a complete surrender or cancellation of the contract, provided the amount does not exceed the aggregate premiums paid under the contract. Such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums. Moreover, § 1031(d) provides that if property is acquired in an exchange described in § 1035(a), then the acquired property's adjusted basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. Accordingly, Treasury and the IRS believe that, under § 1031(d), the adjusted basis of a qualified long-term care insurance contract received in a tax-free exchange under § 1035(a) generally carries over from the life insurance, endowment, annuity, or qualified long-term care insurance contract exchanged.

[4139] Consistent with Letter Ruling 9248013, Letter Ruling 9330040 reasoned and held:

The legislative history of section 1035 of the Code indicates that Congress viewed nonrecognition treatment as appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).

Trust's proposed assignment of Policy to the issuer of New Policy and its receipt of New Policy will qualify as an exchange of one contract of life insurance for another contract of life insurance under section 1035(a)(1) of the Code. At the time of the proposed exchange, the sole remaining insured on Policy will be A. The sole insured on New Policy will also be A. Therefore, the proposed exchange does not involve a change of insured, which would disqualify the transaction from nonrecognition treatment under section 1035.

Accordingly, under section 1035 of the Code no gain or loss will be recognized by Trust upon the exchange of Policy solely for New Policy. Further, the basis of New Policy in the hands of Trust will, as provided in section 1031(d), be the same as Trust's basis in Policy.

We express no opinion on whether section 1035 of the Code applies to the exchange of a survivorship or "second to die" life insurance contract for a single life insurance contract prior to the death of either of the insureds under the survivorship contract. We also express no opinion on whether Policy or New Policy qualifies as a life insurance contract under section 7702(a).

[4140] Letter Ruling 9542037 rejected the application of Code § 1035 in all of the following situations:

Taxpayer has inquired as to several situations involving exchanges by Taxpayer's policyholders who are spouses. In Situation 1, Spouse A exchanges a life insurance contract insuring solely his own life for a second-to-die life insurance contract covering the lives of both Spouse A and Spouse B. In Situation 2, Spouse A exchanges two life insurance contracts, one of which insures

2. The transfer for value rules might cause the death benefit to be subject to income tax.[4141]

When life insurance is sold in a taxable transaction, the IRS' position was that:[4142]

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the life of Spouse A and one of which insures the life of Spouse B, for a second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situation 3, Spouse A and Spouse B jointly exchange separate life insurance contracts each of which insures solely the life of one spouse for a jointly owned second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situations 4A and 4B respectively, the facts are the same as in Situations 1 and 2 except that a trust is the owner and exchanger of the life insurance contracts involved. In none of the Situations do Spouse A, Spouse B or the trust receive any money or other property not permitted to be transferred without the recognition of gain or loss.

It held:

> In each of the Situations described above, the individual insured under each contract given up in the exchange is not the sole individual insured under the contract received in the exchange. As the contracts do not relate to the same insured, any gain realized on the exchange is ineligible for nonrecognition under section 1035 of the Code.

[4141] See text accompanying fns. 4066-4078.

[4142] Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

> **Situation 1**
>
> On January 1 of Year 1, A, an individual, entered into a life insurance contract (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).
>
> On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of cost-of-insurance charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.
>
> A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).
>
> **Situation 2**
>
> The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.
>
> ….
>
> **Law and Analysis**
>
> ….
>
> In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).
>
> Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).
>
> [above two paragraphs were superseded by Rev. Rul. 2020-5, as described in fn 4144.]
>
> **Character of income recognized on sale of the life insurance contract**
>
> Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.

1. The taxpayer's gain is:

   - Ordinary income to the extent that it does not exceed the excess of the policy's cash value over the taxpayer's "investment in the contract" (this excess referred to later as the "inside build-up"),[4143] and

   - Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.

The Supreme Court has held, under the so-called substitute for ordinary income doctrine, that property within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n. 5 (1988) (noting that the substitute for ordinary income doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. *See also Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the substitute for ordinary income doctrine after the Arkansas Best decision).

The substitute for ordinary income doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income. For example, in *Gallun*, 327 F.2d 809, 811 (7th Cir. 1964), the court stated:

> The question presented has been considered by other courts. Uniformly, they have held that the assignment of income doctrine . . . should be applied and the profits realized from the sale or the surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain. These cases are: *First Nat'l Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Rolf v. Commissioner*, 304 F.2d 450 (3d Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Arnfeld v. United States*, 163 F.Supp. 865, 143 Ct. Cl. 277 (1958).

Application of the substitute for ordinary income doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the inside build-up under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See*, *e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). Hence, $14,000 of the $26,000 of income that A must recognize on the sale of the contract is ordinary income under the substitute for ordinary income doctrine. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the remaining $12,000 of income is long-term capital gain within the meaning of § 1222(3).

[4143] Although the IRS did not expressly say so, this policy result is required to preserve the integrity of the system described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy), which also explains why this policy result is required in the text preceding fn. 4159.

However, as mentioned above, Congress retroactively repealed the IRS' position that the selling taxpayer's basis is reduced by the cost of insurance.[4144]

If the policy is a term policy, then the IRS asserts that the basis is any unexpired premiums and the gain is purely capital gain.[4145] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy but must be read in light of the modification to Situation 2 made by Rv. Rul. 2020-5.

Using a life insurance LLC might solve most or all of these issues.[4146]

II.Q.4.d. Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)

To the extent that the distributions are nontaxable death benefits,[4147] the rules described below do not apply.[4148]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4149] Dividends used to pay premiums are not taxable.[4150] Furthermore, loans generally are also not subject to income tax (without reference to the investment in the contract) while the borrower continues to hold the policy[4151] and are treated as distributions when those exceptions apply.[4152] However, distributions

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[4144] See text accompanying fn 4135 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract. Thus, Rev. Rul. 2020-5 modifies the analysis of fn 4142:

> In Situations 2 and 3 in Rev. Rul. 2009-13, under § 1016(a)(1)(B), as added by the TCJA, A is not required to reduce A's basis in the contract by the cost of insurance. Accordingly, in Situation 2 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A must recognize $16,000 of income on the sale of the contract ($80,000 amount realized on sale less $64,000 adjusted basis). In Situation 3 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A will recognize a $25,000 loss on the sale of the contract ($20,000 amount realized on the sale less $45,000 adjusted basis). A will not be permitted to deduct the loss unless the loss is incurred under § 165(c)(1) or (2).

However, Rev. Rul. 2020-5, fn 1 provides:

> Section 13521 of the TCJA only applies to determine a taxpayer's adjusted basis in a life insurance contract under § 1016. Section 13521 of the TCJA does not affect the analysis in Situations 2 and 3 of Rev. Rul. 2009-13 and Situation 2 of Rev. Rul. 2009-14 with respect to the character of any income or loss recognized by a taxpayer on the sale of a life insurance contract.

[4145] Rev. Rul. 2009-13, Situation 1.

[4146] See parts II.Q.4.i Life Insurance LLC, II.M.3 Buying into or Forming a Partnership, and II.Q.8 Exiting From or Dividing a Partnership.

[4147] Code § 101(a)(1).

[4148] Reg. § 1.72-2(b)(1)(i) provides:

> In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

[4149] Code §§ 72(e)(1), 72(e)(2)(B)(ii).

[4150] Code § 72(e)(4)(B).

[4151] Code § 72(e)(4)(A) includes various exceptions.

[4152] Code § 72(e)(4)(A) includes various exceptions.

and loans generally are taxable if the policy is a "modified endowment contract," which generally applies when a policy's premiums are paid too quickly in its initial years.[4153]

Any distributions in excess of "investment in the contract" constitute ordinary income.[4154] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4155]

"Investment in the contract":[4156]

> as of any date is-
>
> (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus
>
> (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4157]

What constitutes "other consideration paid for the contract"? Code § 72(g) tells us what to do when the policy is sold:

> (g) **Rules for transferee where transfer was for value**. Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable

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4153 Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

4154 Code § 72(e)(2).

4155 At the 2015 Heckerling Institute, Larry Brody reported having settled a Tax Court case on this basis. See part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy. Rev. Rul. 2009-13 asserted, without explanation, that Code § 1234A does not apply to a surrender.

4156 Code § 72(e)(6).

4157 Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):

> .02. Section 844(a) of the PPA amended § 72(e) by adding a new paragraph, § 72(e)(11). Section 72(e)(11) provides that a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includible in income. The investment in the contract is reduced (but not below zero) by the charge.
> .03. The PPA did not otherwise amend the definition of "investment in the contract" in § 72(c)(1) and 72(e)(6). Accordingly, the Treasury Department and the IRS believe that all premiums paid for a combination contract that is an annuity and also provides long-term care insurance are generally included in investment in the contract under § 72 if (i) the premiums are credited to the contract's cash value (rather than directly to the long-term care insurance contract that is part of or a rider to the contract), and (ii) coverage under the long-term care insurance contract is paid for by charges against the cash value of the contract. Consistently, a waiver of premiums under such a contract, such as on account of disability or because the annuitant has become chronically ill, should be accounted for in the same manner as a waiver of premiums under other contracts for which "investment in the contract" is determined under § 72(c)(1) or 72(e)(6). See, *e.g.*, *Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952) (waived premiums not treated as constructively received as disability benefits, and therefore not included as part of premium paid for endowment life insurance policy).

consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

Code § 72(g)(2) does not apply, because our income is based on Code § 72(e)(6), not Code § 72(c)(1)(B).

Consider the following potential abuse:

1. Policy owner sells the policy and receives capital gain treatment.

2. Buyer receives a new "investment in the contract" under Code § 72(g).

3. Buyer cashes in the policy, tax-free.

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13, [4158] Situation 2,[4159] prevents this potential abuse.

Thus, if one sells a policy in a taxable transaction:

1. If and to the extent one has gain, the first tier of this gain is ordinary income.[4160]

2. All of the gain on the sale translates into increased "investment in the contract" against which distributions can be taken tax-free.

[4158] See fn 4134 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.
[4159] See fn. 4142.
[4160] See text accompanying fn. 4142.

3. Be careful to fit within an exception to the transfer for value rules[4161] if the buyer expects to receive death benefit in excess of investment in the contract.

II.Q.4.e. Income Tax Issues When the Owner Who Is Not the Insured Dies

Generally, property an individual owns (including indirectly through a partnership[4162]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[4163]

The discussion below focuses on if and the extent to which a life insurance might not get a basis adjustment on the death of an owner who is not insured and then explores practical issues in implementing any basis adjustment that is available.

II.Q.4.e.i. Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured

However, "annuities described in section 72" do not receive a new basis.[4164] Although Code § 72 governs distributions from life insurance companies to policy owners, this provision appears to be aimed at annuity contracts and not life insurance contracts.

Of greater concern is whether the internal build-up in a cash value life insurance contract constitutes "income in respect of a decedent" (IRD) ineligible for a basis adjustment.[4165] Regulations provide:[4166]

> **General definition.** In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes-
>
> (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
>
> (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and
>
> (3) Income to which the decedent had a contingent claim at the time of his death.

[4161] Code § 101(a)(2).
[4162] Generally, the partnership need to have a Code § 754 election in place for the partnership's taxable year in which the individual dies or in certain situations when that person's interest in the partnership is later transferred. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[4163] Code § 1014, which applies to more than just what this sentence describes.
[4164] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).
[4165] Code § 1014(c).
[4166] Reg. § 1.691(a)-1(b).

Income is "accrued" when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[4167]

IRD does not include "items which are excluded from gross income under subtitle A."[4168]

When the owner who is not the insured dies, we do not know whether the policy's value in excess of "investment in the contract" (such excess, the "inside build-up") is going to be includible in income (if taken out before the insured dies)[4169] or excluded from income (if received as a nontaxable death benefit).[4170] In other words, it is not true that "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Therefore, the inside build-up has not "accrued" upon that owner's death and cannot constitute IRD.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4171]

[4167] Reg. § 1.451-1(a). On the deduction side, see *U.S. v. General Dynamics Corp.*, 481 U.S. 239 (1987); U*.S. v. Hughes Properties, Inc.*, 476 U.S. 593 (1986); Rev. Rul. 78-212; *Giant Eagle, Inc. v. Commissioner*, 822 F.3d 666 (3rd Cir. 2016), *rev'g* T.C. Memo. 2014-146. In addition to the all events test, the Code § 461(h) economic performance rules may defer deductions.
Enacted by 2017 tax reform, Code § 451(b), "Inclusion not later than for financial accounting purposes," may accelerate income for taxpayers with certain financial statements. Regulations are at https://www.federalregister.gov/public-inspection/2020-28653/taxable-year-of-income-inclusion-under-an-accrual-method-of-accounting-and-advance-payments-for.

[4168] Reg. § 1.691(a)-1(c).

[4169] Code § 72(e).

[4170] See fns. 4147-4148.

[4171] *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), summarizing the Tax Court's holding. Although the Eighth Circuit agreed with the Tax Court's holding and pointed out that the IRS agreed with the test when it appealed, it held that lack of delivery of the sold goods sufficed to prevent IRD treatment:

> Here, the task remaining to be performed by the estate was performance of the contract. We agree with the conclusion of the Tax Court that performance of the contract, which, under the circumstances, involved care and feeding of livestock and delivery, cannot be characterized as a ministerial or minor act. However, we think that characterization of the tasks which remain after the death of the decedent should not necessarily depend upon the nature of the subject matter of the sales transaction. For example, the subject matter of the sales transaction in the present case was livestock, which obviously required care and feeding. What if the subject matter was not livestock but logs or refrigerators? It would still be the task of the decedent's transferee to deliver or otherwise dispose of the logs or refrigerators, even though that type of property does not require the care that livestock does.
>
> We recognize that the analysis followed by the Tax Court emphasizes delivery or disposal of the subject matter of the sales transaction and, to a certain degree, discounts the significance of the sales contract. Compare Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 Wash. U.L.Q. 30, 37-38 (proposing that §691 should apply to sales proceeds if the contract of sale is incomplete at death "only as to delivery of the res and receipt of the purchase price"). Nonetheless, this analysis is not inconsistent with *Trust Co. v. Ross*, *supra*, 392 F.2d at 697, where the contract of sale was executed and the stock was placed in escrow before the death of the decedent and the tasks remaining for the estate were "minor," and *Commissioner v. Linde*, *supra*, 213 F.2d at 4-8, where the decedent had delivered the property before death to the marketing cooperative, thus "converting" the property into a right to receive income. Moreover, "while the death of a decedent can be a fortuitous event tax-wise, it is certainly hard to visualize death as a tax avoidance scheme." Note, Sales Transactions and Income in Respect of a Decedent, *supra*,

(1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,[5]

(2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,[6]

(3) whether there existed at the time of the decedent's death any economically material contingencies which might have disrupted the sale,[7] and

(4) whether the decedent would have eventually received the sale proceeds if he or she had lived.[8]

74 T.C. at 639-41.

[5] As noted by the Tax Court, "[t]his arrangement may take a variety of forms: an express executory contract of sale [as in *Trust Co. v. Ross*, *supra*, 392 F.2d 694]; an implied contract for sale [A delivers apples to Y, Y accepts the apples, A dies before Y can pay for them]; or a contractual arrangement with a cooperative marketing association [as in *Commissioner v. Linde*, *supra*, 213 F.2d 1 (no contract or sale, just delivery of grapes to marketing cooperative; proceeds held income in respect of a decedent when received)]."

> 3 Ga. L. Rev. at 615. After all, the decedent in a sales case does not prearrange his death in order to shift the responsibility for delivering the subject matter of the sale transaction to his executor or to take advantage of the fair market value basis rule of § 1014(a) and thus avoid the reach of § 691.

However, the IRS does not appear to agree with the Eighth Circuit's emphasis on delivery. Rev. Rul. 82-1 involved the following facts:

> A taxpayer, who used the cash receipts and disbursements method of accounting, held title to a personal residence solely in the taxpayer's name. The taxpayer met all the age, use, and holding requirements of section 121 of the Code relating to the treatment of gain from sale or exchange of a principal residence by an individual who has attained age 55. The taxpayer had not previously made an election under section 121 with respect to any prior sale.
>
> The taxpayer entered into a binding executory contract to sell the residence and accepted a down payment. The terms of the contract called for delivery of the deed and possession of the property upon receipt of the balance of the purchase price. After substantial fulfillment of the prerequisites to consummation of the sale and with only ministerial obligations remaining to be performed under the contract, but prior to closing the sale, the taxpayer died and the sale was completed when the executor of the taxpayer's estate received payment in full and delivered the deed.

Rev. Rul. 82-1 held:

> Consistent with the extension of rights and privileges accorded a fiduciary under section 6903, the executor may "stand in the shoes" of the decedent for purposes of making the election under section 121, with respect to the sale of the residence described herein. However, if the executor chooses not to make the election under section 121, or to the extent that the gain exceeds the amount excludable under section 121, the provisions of section 691(a), relating to income in respect of a decedent, will apply. Rev. Rul. 78-32.

In *Trust Co. of Ga. v. Ross*, 392 F.2d 694 (5th Cir. 1967), *aff'g* 262 F.Supp. 900 (N.D. Ga. 1966), cert. denied 393 U.S. 830 (1968), the decedent had fully performed, but the buyer had not met financing contingencies and other contingencies out of the decedent's control remained. The Fifth Circuit found IRD:

> When the facts in these cases are all viewed, it is readily apparent that the proceeds in issue were realized as a consequence of negotiations and an enforceable contract made by Mr. Dinkler, Sr., during his lifetime, and not the result of any material acts or activities by the estate. The right to the proceeds was acquired by the plaintiffs solely by virtue of the death of the decedent and not through their own efforts. Had Mr. Dinkler lived through the closing date, the proceeds would have been income to him and, consequently, they constitute income in respect of a decedent when received by the estate.

> *Estate of Peterson v. Commissioner*, 74 T.C. 630, 639 (1980) (parentheticals substituted and expanded). *See also Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981) (the right to income need not be legally enforceable).
>
> [6] "One indicium of whether a decedent has performed the applicable substantive acts is whether he has delivered, or somehow placed, the subject matter of the sale beyond his control prior to his death." *Estate of Peterson v. Commissioner*, *supra*, 74 T.C. at 640. *Compare* M. Ferguson, J. Freeland & R. Stephens, *Federal Income Taxation of Estates and Beneficiaries*, *supra*, 180-84 ("[E]vend where the property has been made the subject of a binding, executory contract of sale, if the benefits and hazards of ownership are still possessed by the decedent at his death, the property is entitled to a § 1014(a) basis in the hands of his estate, and his negotiated profit will not be taxed to his estate (or to anyone) under § 691 when the sale is completed after his death.") (footnote omitted), with Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 *Wash. U.L.Q.* 30, 37 (§ 691 should apply to sale proceeds from sales which at the time of the decedent's death are incomplete "only as to delivery of the *res* and receipt of the purchase price").
>
> [7] *Cf. Keck v. Commissioner*, *supra* 415 F.2d at 534 (sale of stock was contingent upon Interstate Commerce Commission approval; proceeds held not income in respect of decedent where ICC approval not granted at time of the decedent's death).
>
> [8] *See* 26 C.F.R. § 1.691(a)-2(b) (Ex. 4) (buy-sell agreement effective at date of death; proceeds not income in respect of a decedent because the decedent could not have received the proceeds if he had lived).

The Tax Court in that case held:[4172]

> Although three of the four requirements tend to support a conclusion opposite to the one reached, all four elements are necessary to support a finding that the decedent possessed a right to the sale proceeds as of his date of death. [fn. omitted] Accordingly, the absence of one of these requirements precludes the applicability of section 691.

In analyzing the requirement that was missing, the Tax Court said:[4173]

> The fourth requirement is that the decedent, himself, would have eventually received (actually or constructively) the sale proceeds if he had lived. This situation may be best exemplified by a typical date-of-death buy-sell agreement between a decedent and his corporation; since, by its terms, the sale is only effective upon the decedent's death, the decedent could not have received the sale proceeds if he had lived. Therefore, the proceeds from such a sale are not income in respect of a decedent.

(Related to this is the "open transaction" doctrine. See part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public, discussing the prepaid variable forward Tax Court case of *Estate of Andrew J. McKelvey v. Commissioner* (see fn 56)).

[4172] 74 T.C. at 643-44.

[4173] 74 T.C. at 641. In a case involving a similar issue, farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return, even though their expected use was obvious. See *Backemeyer*, discussed in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

Applying the Tax Court's fourth requirement to the insurance policy analysis, would the decedent have received taxable income from the policy if the decedent/policy owner had lived? The answer is not necessarily – if the insured died while the policy owner was living, the policy owner would have received a tax-free death benefit. The answer would be different if the policy owner had submitted the appropriate forms to cash out the policy before the policy owner died and the insurance company simply had not cut the check before the policy owner died. Thus, if the policy owner has not, before the policy owner's death, submitted whatever documentation is required to cash in the policy, then the events fixing the policy's tax consequences have not occurred before the policy owner's death and the internal cash build-up obtains a basis step-up because it does not constitute IRD.

Insurance companies remain concerned because they view the inside build-up as vested untaxed earnings. Although this argument seems untenable for contracts whose cash value might later decrease, for fully paid whole-life they understandably view it as absolute earnings that will never decrease. Rev. Rul. 2009-13[4174] took the position that, on the sale of a life insurance contract, the gain on sale is ordinary income to the extent that it does not exceed the inside build-up.[4175] The substitute-for-income doctrine, under which the IRS states that the asset is not a capital asset to the extent that the doctrine applies, makes them view the inside build-up as IRD. What they do not take into account is that assets that generate ordinary income on sale, such as inventory (which is not a capital asset),[4176] do not constitute IRD unless actually sold before death; an asset's character as an ordinary income asset has nothing to do with IRD characterization unless the income is "accrued"[4177] or is a specified class of assets subject to IRD, neither of which applies to a life insurance contract. If and to the extent that a policy might not constitute a capital asset,

[4174] See fn 4134 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4175] See fn. 4142.

[4176] Code § 1221(a)(1) provides:

> For purposes of this subtitle, the term capital asset means property held by the taxpayer (whether or not connected with his trade or business), but does not include … stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Note that real estate might or might not constitute inventory. See part II.G.14 Future Development of Real Estate, especially fn. 1536.

[4177] Rev. Rul. 58-436. However, crop shares or livestock received as rent by a decedent, who had employed the cash method of accounting, before the decedent's death, and owned by the decedent at the time of the decedent's death, as well as crop shares or livestock which the decedent had a right to receive as rent at the time of the decedent's death for economic activities occurring before the decedent's death, constitute income in respect of a decedent which is required to be included in gross income, for Federal income tax purposes, in the year in which the crop shares or livestock are sold, or otherwise disposed of. Rev. Rul. 64-289. *Friedman v. Commissioner*, 41 T.C. 428 (1965), *aff'd* 346 F.2d 506 (6th Cir. 1965) and Rev. Rul. 69-102 were disturbed when a taxpayer sought a charitable deduction for the full value of life insurance policies and therefore taxed the taxpayer on ordinary income on the policies' inside build-up based on a combination of the assignment-of-income principle and the taxpayers realizing a benefit (charitable deduction) for that income; Code § 170(e) and Reg. § 1.170A-4(a) address this issue by not permitting a deduction on the portion of the policy that would constitute ordinary income if the policy were sold, so presumably these authorities are obsolete in light of Rev. Rul. 2009-13. Rev. Rul. 69-102 involved an endowment policy, which typically provides for a payout of the accrued income on a specified maturity date, so before the gift all events had occurred that would require the payout of the inside build-up. Once a policy has been annuitized, an assignment triggers the assignment of income doctrine, *Jones v U.S.*, 395 F.2d 938 (6th Cir. 1968), but that should not apply to a policy passing by reason of death to the extent that the policy had not been annuitized.

that classification is irrelevant, because the Code § 1014 basis step-up rules apply to more than just capital assets.[4178] Furthermore, Rev. Rul. 2009-13 did not say that inside build-up creates gain; it merely said that inside build-up recharacterizes part or all of the gain on sale of the policy as ordinary income. Of course, Rev. Rul. 2009-13 has been retroactively repealed,[4179] so my mention of it simply provides context in which to analyze these issues.

Thus, although the potential ordinary income taxation of inside build-up might make one inclined to view it as IRD, that view has no basis in the law, although I found one probably irrelevant and unsound source that the IRS might try to seize upon in the event of an audit.[4180]

II.Q.4.e.ii. Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured

The only direct immediate practical use of a stepped-up basis is avoiding gain on sale. After all, the death benefit is tax-free if one avoids the transfer for value rules (see part II.Q.4.a Funding the Buy-Sell). The remaining big question is any effect on distributions of inside build-up, the taxation of which depends on the "investment in the contract" under Code § 72(g).

The estate of the decedent who is not the insured does not appear to receive a new "investment in the contract" because the contract was not transferred to it "for a valuable consideration." However, if that estate later sold the policy for full value to a different taxpayer:

- The estate would have a stepped-up basis.
- The transferee would have a new "investment in the contract."
- The transferee would need to make sure that the "transfer for value" rules[4181] do not make the death benefit taxable.[4182]

Before buying a cash value policy to be includible in the estate of a person who is not the insured or that might be transferred in a taxable sale (perhaps one that avoids the transfer for value rules),

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[4178] For example, nobody has ever suggested that a depreciable building used in a business is not eligible for a new basis under Code § 1014, even though Code § 1221(a)(2) provides that such a building is not a capital asset. See*, e.g.*, Reg. §§ 1.1245-2(c)(1)(iv) and 1.1250-3(b)(2)(i), providing that Code § 1014 can wipe out depreciation recapture when such property is included in the deceased owner's estate. See also the quotes from the U.S. Supreme Court and Tax Court in the text accompanying fn. 2006, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4179] See fn 4134 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4180] Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being good law) took the position that stock, which has net unrealized appreciation (NUA) that was not taxed when distributed from a qualified retirement, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 4171), and I believe it is simply wrong in light of *Peterson*, because there is no assurance that the gain will ever be realized, and the ruling did not cite any particular support in reaching the conclusion it did. It is also philosophically inconsistent with the IRS' failure to assert assignment of income principles or otherwise impose any taint when NUA property was given to charitable remainder trusts in Letter Rulings 200038050, 200202078, 200215032, 200302048, and 200335017.

[4181] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4066-4078.

[4182] Nothing in Code § 72(g) or Reg. § 1.72-10 suggests that an exception to the transfer for value rules (other than a substituted basis transaction) would make the contract not transferred for a valuable consideration.

consider asking the insurance company its procedures in this area. Results from that inquiry include the following:

- "We never undertake to make a Code § 72(g) adjustment, because we don't want to be bothered with it." If the insurance company answers that way, ask whether they will honor a request to check the box "taxable amount not determined" so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.

- "We don't want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this." To obtain that Form 1099 reporting, the policy owner's estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns policy on Daughter's life. Dad dies. Dad's estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new "investment in the contract." Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son's basis due to his purchase from Dad's estate, and Daughter's purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box "taxable amount not determined."

II.Q.4.f. Split-Dollar Arrangements

II.Q.4.f.i. Split-Dollar Generally

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.[4183] If an employer buys insurance on an employee's life and allows the employee to designate the beneficiary, that arrangement may constitute an ERISA plan.[4184] The IRS has an audit techniques guide on split-dollar arrangements.[4185]

The IRS created split-dollar rules before the U.S. Supreme Court found that interest could be imputed on loans and before Code § 7872 was enacted. During that period, the employer would

[4183] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015). This case involved seven taxpayers, and the parties in approximately 40 other cases agreed to be bound by the result of this case. Notice 2007-83 announced that the IRS would target welfare benefit plans funded by life insurance. Notice 2007-84 announced that the IRS would target certain multi-employer welfare benefit plans. Program Manager Technical Advice 2015-11 explains how to apply the 30% accuracy-related penalty under Code § 6662A(c), to taxpayers who didn't follow the requirement of Notice 2007-83 to disclose participation in a listed transaction that used cash value life insurance policies to provide welfare benefits in a purported Code § 419 plan. The IRS successfully penalized Keller Tank Services II, Inc., one of the employers in the *Our Country Home Enterprises* case, for failure to report its participation in the plan as a "listed transaction" on its tax return. *Keller Tank Services II, Inc. v. Commissioner*, 854 F3d 1192 (10th Cir. 2017).

[4184] And it did in *Alberth v. Southern Lakes Plumbing & Heating, Inc.*, 2020 WL 1082775, 2020 Employee Benefits Cas. 84,566 (E.D. Wis. 3/6/2020) (Docket No. 19-CV-62).

[4185] See http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-(03-2005) and www.irs.gov/businesses/corporations/article/0,id=136548,00.html.

retain the premiums it paid when the arrangement terminated (whether by death or by unwinding the arrangement – the latter referred to as a "rollout"), and the employee's beneficiary (or employee on rollout) would receive the death benefit (or cash value in the case of a rollout) after reimbursing the premiums paid.[4186] It needed a mechanism to tax long-term interest-free loans, which is what split-dollar was essentially at that time, but without a promissory note. Under that system, the employer was treated as owning the policy and providing taxable economic benefits to the employee each year equal to the value of one year of life insurance protection. This treatment applied whether the employer or employee owned the policy. To avoid estate tax on the death benefit, an irrevocable life insurance trust ("ILIT") would own the policy, so that each year's imputed income to the employee was also a gift to the trust. Eventually, the arrangement would be undone before the employee's death, whether because the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy's cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

Now split-dollar arrangements are governed by Reg. § 1.7872-15, under which premium payments generally are treated as loans, or Reg. § 1.61-22, the "economic benefit regime," under which generally one person is treated as owning all of the policy's cash value and the other person pays, or is treated as paying, for one-year term life insurance to the extent of the death benefit not allocated to the owner or deemed owner.

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement. The other version involves the premium payor being treated as making loans to the policy owner. Generally, interest is actually paid when the insured dies but treated as paid every year,[4187] and the parties need to make an election to give effect to the loan for income and gift tax purposes.[4188] See part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

For the treatment of the economic benefit regime before Reg. § 1.61-22 was promulgated, agreements entered into on or before September 17, 2003 are instead subject to IRS Notices 2001-10 and 2002-8[4189] and Rev. Rul. 2003-105, so long as they are not "materially

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[4186] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

[4187] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See text accompanying fns 4235-4240 in part Split-Dollar Loans under Reg. § 1.7872-15.

[4188] See text accompanying fns 4249-4250 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4189] Notice 2002-8 discusses the extent to which changes in the IRS' view might affect arrangements then in effect:

> **VI. Effect On Other Documents**
>
> Notice 2001-10 is revoked. Notwithstanding that revocation, Rev. Rul. 55-747 remains revoked, and Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110 remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans.

modified." Reg. § 1.61-22(j) lists some unenlightening safe harbors for what does not constitute a material modification. "Material modification" for this purpose includes changes that would not constitute a material modification under Code § 101(j) (employer-owned life insurance)[4190] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[4191]

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[4192] Although the Code § 409A risk described in fn. 4192 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[4193]

All split-dollar arrangements require an exit strategy. For the loan regime, somehow the loans must be repaid; however, they do not need to be repaid until the insured's death, so the exit strategy might be easy. For the economic benefit regime, the deemed term portion becomes prohibitively expensive when the insured reaches a certain age, and it is not unusual for the parties not to have planned for how the non-owner obtains ownership for tax purposes (even though they should have). For split-dollar agreements entered into on or before September 17, 2003, when the policy is rolled out with the non-owner merely repaying the premiums:

- The equity (excess of policy value over amount owed the owner) may be taxable, but the no-inference language in fn 4189 supports a reasonable basis argument that lets one take a tax return reporting position that the equity is not taxable, so a taxpayer can take the position, file Form 8275, and see what happens. *Neff v. Commissioner*, T.C. Memo. 2012-244, accepted the IRS' position that the taxpayer had taxable income to the extent that the amount the taxpayer owed the employer on rollout exceeded the amount the employee paid the employer (rather than the employee's argument that the present value of the amount payable at death

> Except for Part III (Revised Standards for Valuing Current Life Insurance Protection), no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations. However, taxpayers may rely on this notice (including a reasonable application of the rules to be proposed as described in Part II) or Notice 2001-10 for split-dollar life insurance arrangements entered into before the date of publication of final regulations.

I am aware of a taxpayer who took the position of no income or gift on rollout, filed Form 8275, received a brief question from the IRS, and then heard nothing before the statute of limitations passed. See Thompson Coburn doc. 6348842 (email from an outside lawyer to that effect).

[4190] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance, especially part II.Q.4.g.i Analysis of Code § 101(j).

[4191] Notice 2008-42.

[4192] See text accompanying fns. 4042-4043.

[4193] Reg. § 1.409A-1(b)(1) provides:

> A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income….

Generally, for post-2003 split-dollar agreements, the employee will have to pay for the policy's value under part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22; however, one might want to clarify that the employee will need to pay the greater of the amount provided under the regulations or the policy's fair market value, which as a practical matter would likely to be the value on Form 712. For pre-2003 agreements that are not materially modified, the employee paying the cash surrender value would suffice. Given that these older arrangements might not require the employee to pay the cash surrender value, one should look to Notice 2007-34 to try to make the policy qualify for being grandfathered from Reg. § 1.61-22 and comply with Code § 409A.

was the proper measure). It appears that nobody considered whether the employee should have been taxable on the policy's value, which exceeded the amount owed to the employer.

- However, if I can find a way to avoid doing that, I will. For example, if the employer can use the deduction (or is a pass-through entity whose owners can use the deduction), then the employer can afford to gross them up for taxes, because the employer is saving taxes by taking that reporting position. A classic example: Employer and employee are both in the federal and state combined 40% bracket, and the amount of equity is $100. The employer pays the employee a $67 bonus so that the employee can pay the employee's taxes. The employee's taxes are $67, which is 40% of $167, the latter being the sum of the $100 policy value and the $67 bonus. The employer saves $67 taxes by reporting the same $167 compensation value, so the employer is not out-of-pocket anything.

- I successfully use the above strategy most of the time. However, the paradigm falls apart when the employer's tax benefit is less than the employee's tax cost, which often happens when the employer has little taxable income from operations against which to use the deduction. And my solution does not address estate/gift tax issues. So sometimes we need to fall back to the taxpayer taking the position that the equity is not taxable. And I have not heard any war stories about the IRS auditing this issue.

The loan regime can be somewhat unwieldy, in that each year's premium requires a separate loan. Furthermore, the economic benefit regime tends to be most beneficial to the non-owner in the policy's early years, in which the premiums paid tend to exceed the policy's cash value. Considering these issues, one might consider starting with the economic benefit regime and the switching to the loan regime when cash value approaches premium paid. This switching approach avoids administering and accruing interest on multiple loans in the policy's early years and allow cash value increases after that point to benefit the party that originally was the non-owner. By the time the switch occurs, the policy might very well be earning enough dividends to pay premiums, perhaps avoiding the need to administer multiple loans to pay for those future premiums. If the original non-owner is an irrevocable trust, during the economic benefit phase (and of course later) the grantor can make annual exclusion gifts to the trust and perhaps even use leveraged estate planning techniques[4194] to grow the trust so that the trust can afford to pay future premiums and perhaps even retire the split-dollar loans.

II.Q.4.f.ii. Technical Details of the Split-Dollar Economic Benefit Regime

II.Q.4.f.ii.(a). Is the Arrangement a Split-Dollar Arrangement?

Generally, in the split-dollar economic benefit regime, the idea is give only pure term protection to the "non-owner" and all other right to the actual or deemed "owner."

Reg. § 1.61-22(b)(1) provides:

> *In general*. A split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria -

[4194] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

(i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;

(ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

Even if the above requirements are not met, any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement if it qualifies as a certain compensatory arrangement or shareholder arrangement.[4195]

The following constitutes a split-dollar compensatory arrangement:[4196]

(A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;[4197]

(B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

[4195] Reg. § 1.61-22(b)(2)(i).

[4196] Reg. § 1.61-22(b)(2)(ii).

[4197] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth, including the requirement of Reg. § 1.79-1(a)(4) that a group term arrangement not involve individual selection:

> Guardian and Minnesota Life required that the Our Country and Environmental shareholder/employees tender information on their health, traveling tendencies, and/or driving traits. The need to submit that type of personal information as a condition to receiving the insurance strongly suggests, and we find, that the insurers were exercising underwriting judgment with respect to at least the Our Country and Environmental shareholder/employees in connection with the issuance of the life insurance related to them. This finding is further strengthened by the fact that, in the case of Guardian at least, Guardian specifically rated each of Our Country's participating employees for purposes of setting the premiums payable on their policies and offered to try to find a way to reduce the premium attributable to the Blake policy. The mere fact that an insurer such as Guardian or Minnesota Life may add up the premiums that apply to separate policies that it sells on a specific group of insureds and then tender the total as the amount due on a group policy does not necessarily recharacterize the separate policies as part of a single group term life insurance plan. Instead, as we have stated, the exercise of underwriting judgment with respect to the specific persons in a group is indicative of the issuance of individual insurance policies rather than group policies. We hold that the insurance policies at hand are not group term life insurance policies for Federal income tax purposes.

De Los Santos v. Commissioner, T.C. Memo. 2018-155, followed *Our Country Home*. In contrast, if a group-term policy allows employees to buy additional pure term insurance on an after-tax basis without any such purchases affecting the employer-provided group plan, the employees' independent choices do not affect the employer-provided group plan's qualification as such. Letter Ruling 201542003.

(1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or[4198]

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.[4199]

[4198] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

> The shareholder/employees named the beneficiaries of the death benefits payable under their insurance policies by designating through the Sterling Plan the individuals who would receive the death benefits under the plan, which, in turn were the death benefits under the policy. In addition, those shareholder/employees were assured that their designated beneficiaries would receive any death benefits payable on those policies to the extent that the shareholder/employees died while participants in the plan. Petitioners seek a contrary holding essentially by looking at the life insurance policies through the wider end of a telescope towards its narrower end and seeing that the Sterling Plan is named as the beneficiary on the policies. They conclude from this view that none of the individuals who the participating employees designate to receive the death benefits payable by the Sterling Plan is [t]he beneficiary of all or any portion on the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. We, on the other hand, look telescopically at the life insurance benefit from the narrower end towards the wider end, as one commonly does, and see the ultimate recipient of the death proceeds as the person designated by the shareholder/employees. The fact that the death proceeds from the life insurance policies are funneled through the Sterling Plan to each of the ultimate recipients does not blur our view (or our conclusion) that each of those recipients is the beneficiary of the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. *Cf. Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (To permit the true nature of a transaction to be disguised by mere formalisms *** would seriously impair the effective administration of the tax policies of Congress.); *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (A given result at the end of a straight path is not made a different result because reached by following a devious path.). The light at the end of the tunnel brightly illuminates our conclusion, given that the Sterling Plan would pay no death benefit were it not for the life insurance policies, and the employee to whom a policy relates, rather than the Sterling Plan, is assured of receiving the entire amount that is payable under the terms of the policy.

[4199] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

> We also conclude that the shareholder/employees of Our Country and Environmental had interests in the their life insurance policies and the cash values thereof. This conclusion is supported by at least five facts. First, each life insurance policy and any funds related thereto were intended to be received by the corresponding employee or his or her designee(s) and no one else, and those employees were the only ones who had the right to receive or otherwise to redirect to someone else the cash value of the life insurance policies related to them. Second, the employees could elect to receive their policies upon retiring from employment with the employer. Third, the funds in the Sterling Plan could not be accessed by either the employer or by the employer's creditors, and Our Country and the Environmental employees, upon retiring or alternatively upon their employers' ceasing participation in the Sterling Plan, were certain to get those funds in the form of the policies that then passed to the employees. Fourth, a participating employee, before actually receiving the funds in his or her account, could be allowed to direct the investment of those funds and thus enjoy the benefit of any investment gain or suffer the detriment of any investment loss. Fifth, if the participating employee were to die while his or her insurance policy was in force, then the death benefit under that policy would ultimately be paid to his or her beneficiary in accordance with the terms of the policy.

If an employer funds a split-dollar arrangement using a Code § 419(e) welfare benefit fund, the employer and employee retain their status as such under the split-dollar arrangement notwithstanding the fund's role and notwithstanding any delay in the fund remitting premiums to the insurance company.[4200]

The following constitutes a split-dollar shareholder arrangement:[4201]

(A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;

(B) The corporation pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or

(2) The shareholder has any interest in the policy cash value of the life insurance contract.

II.Q.4.f.ii.(b). Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22

The rules below apply for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).[4202] Generally, the split-dollar economic benefit regime[4203] applies to any arrangement that is not subject to the split-

We also find important to our just-stated conclusion that the plan benefits were set to be fully vested either when a shareholder/employee satisfied the vesting requirements that he or she chose (or possibly could choose) in the name of the employer or when the employer terminated the plan. And as to vesting, the shareholder/employees were not necessarily bound by the vesting requirements that were initially set in their plans. Instead, at their whim they could accelerate or otherwise change the vesting requirements to their preference. In the case of Mr. Blake, for example, he executed an adoption agreement on July 30, 2006, retroactive to January 1, 2005, that lowered the normal retirement age for the employee participants in the Our Country plan and accelerated his complete vesting to the then-present time.

[4200] *De Los Santos v. Commissioner*, T.C. Memo. 2018-155.

[4201] Reg. § 1.61-22(b)(2)(iii).

[4202] Reg. § 1.61-22(a)(1) provides:

In general. This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA). For the Collection of Income Tax at Source on Wages, this section also provides rules for the taxation of a split-dollar life insurance arrangement, other than a payment under a split-dollar life insurance arrangement that is a split-dollar loan under § 1.7872-15(b)(1). A split-dollar life insurance arrangement (as defined in paragraph (b) of this section) is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872-15, or general tax rules. For rules to determine which rules apply to a split-dollar life insurance arrangement, see paragraph (b)(3) of this section.

Noticeably absent from the list in the first sentence is estate tax, the consequences of which are provided in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

[4203] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015).

dollar loan regime.[4204] It also applies to a loan arrangement if the following requirements of Reg. § 1.61-22(b)(3)(ii) apply:

(A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

Generally, "with respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.[4205]

However:[4206]

(1) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section; and

(2) A donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section.

Note that (1) above does not prevent an employee from setting up an endorsement arrangement with the employer, in which the employee owns the policy (including cash surrender value) and pays the premiums and the employer pays for some current life insurance protection. In such an arrangement, the employee's interest in the cash value means that current life insurance protection is not the employee's only interest in the policy; therefore, the employee's being named as the policy owner also makes the employee the owner for tax purposes.

Similarly, in a donor-donee economic benefit split-dollar agreement, if the donee is designated the owner of the life insurance policy, then the donee will be treated as the owner for tax purposes if the donee has any interest other than current life insurance protection. Although the donee having actual ownership of the policy would seem risky for this reason, such an arrangement

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[4204] Reg. § 1.61-22(b)(3)(i).

[4205] Reg. § 1.61-22(c)(1)(i), which further provides:

> If two or more persons are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. If two or more persons are named as policy owners of a life insurance contract but each person does not have, at all times, all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

[4206] Reg. § 1.61-22(c)(1)(ii)(A).

might save estate tax if the donor is not the insured, as described in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.[4207]

For these purposes, Reg. § 1.61-22(d)(3)(i) provides:

> the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid for by the non-owner under paragraph (d)(1) of this section for the current taxable year or any prior taxable year.

Reg. § 1.61-22(d)(1) provides:

> In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, economic benefits are treated as being provided to the non-owner of the life insurance contract. The non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits described in paragraph (d)(2) of this section, reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

Machacek v. Commissioner, T.C. Memo. 2016-55, held that a split-dollar agreement benefitting a shareholder-employee was a compensatory plan, causing income inclusion to the shareholder-employee. The Sixth Circuit reversed, 906 F.3d 429 (2018), ignoring both parties' briefs and instead citing Reg. § 1.301-1(q)(1), "Split-dollar life insurance arrangements," which provides:

> (i) *Distribution of economic benefits*. The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) or of amounts described in § 1.61-22(e) is treated as a distribution of property, the amount of which is determined under § 1.61-22(d) and (e), respectively.
>
> (ii) *Distribution of entire contract or undivided interest therein*. A transfer (within the meaning of § 1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to § 1.61-22(g)(1) and (2).

[4207] Especially fns. 4271-4273.

The Sixth Circuit stated that Reg. § 1.301-1(q)(1)(i) did not differentiate between compensatory and non-compensatory split-dollar arrangements and noted that this was not inconsistent with Reg. § 1.61-22(d)(1), which specifically contemplates that Code § 301 may apply to a split-dollar arrangement. Although such a disproportionate distribution should be cured if an S election is in place, it almost never will cause the corporation to violate the single-class-of-stock rule.[4208]

The requirement that the non-owner receive only current life insurance protection means that the non-owner cannot have any other economic benefits, such as current or future access to cash value.[4209] Policy cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.[4210] A non-owner has current access to that portion of the policy cash value (A) to which the non-owner has a current or future right and (B) that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.[4211] Note that the policy's being

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[4208] See part II.A.2.i Single Class of Stock Rule, especially parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences (especially fn 256, citing Reg. § 1.1361-1(l)(2)(i)) and II.A.2.i.iii Disproportionate Distributions.

[4209] Reg. § 1.61-22(d)(2) provides:

> *Value of economic benefits*. The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals—
>
> (i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;
>
> (ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and
>
> (iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

[4210] Reg. § 1.61-22(d)(4)(i).

[4211] Reg. § 1.61-22(d)(4)(ii). *De Los Santos v. Commissioner*, T.C. Memo. 2018-155, held:

> Petitioners had a "future right" to the Policy cash value because they had the exclusive right to designate who would receive death benefits under the Policy. *See Our Country Home Enters.*, Inc., 145 T.C. at 45-46, 53-54. Moreover, once a participating employer had made contributions to the Legacy/Flex Trust, those contributions were irrevocable and were inaccessible to the employer and its creditors. Employers and their creditors likewise had no access to the income or assets (including insurance contracts) held by the Legacy/Flex Trust. Thus, although petitioners during 2011-2012 could not withdraw funds from the Policy or the Legacy/Flex Plan, the Policy cash value, in its entirety, was "inaccessible to the owner" (*i.e.*, the S Corp.) and was "inaccessible to the owner's general creditors." See sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.[4]
>
> [4] Petitioners insist that they enjoyed no economic benefit beyond the cost of current insurance protection—i.e., $178 for 2011 and $213 for 2012—because they could not withdraw cash from the Policy or from the Legacy/Flex Plan currently. This argument ignores the governing regulation, which explicitly states that a non-owner possessing future rights "has current access to that portion of the policy cash value" that is "inaccessible to the owner" or "inaccessible to the owner's general creditors." Sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.
>
> Although the Legacy/Flex Plan documents make clear that the Policy cash value was not subject to the claims of any participating employer or its creditors, petitioners assert that a clawback provision in the bankruptcy code could lead to a different outcome. Under 11 U.S.C. sec. 548(e)(1) (2012), a bankruptcy trustee may claw back any transfers made by a debtor within 10 years of the petition date if the transfer (among other things) was made to a self-settled trust or to a similar device whose beneficiary was the debtor. This provision is irrelevant here. The Legacy and Flex Trusts were not self-settled trusts. And the S Corp., the debtor in the scenario petitioners imagine, was not a beneficiary of the Legacy or Flex Trust. We accordingly hold that petitioners had "current access" to the entire cash value of the Policy during 2011 and 2012.

inaccessible to the owner is not enough to attribute cash value to the non-owner; the non-owner must also have a current or future right to the cash value.[4212]

[4212] See fns. 4271-4273, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

> **Section 2.01. <u>Policy Ownership</u>.**
>
> (a) The Trust be the sole and absolute owner of the Policy. and may exercise all ownership rights granted to the owner thereof under the term of the Policy, except as otherwise provided in and limited by this Agreement.
>
> (b) It is the intention of the parties to this Agreement and the purpose of the Collateral Assignment that the Trust shall retain all rights that the Policy grants to the owner thereof, except as otherwise provided in and provided by this Agreement. The sole right of the Donor under this Agreement and under the Collateral Assignment shall be to be repaid the amount due to Donor under this Agreement. Specifically, but without limitation, the Donor shall neither have nor exercise any right as collateral assignee of the Policy that could in any way defeat or impair the Trust's right to receive the Policy Cash Value or the death benefit of the Policy in excess of the total amount due to the Donor under this Agreement. All provisions of this Agreement and of the Collateral Assignment shall be construed so as to carry out such intention and purpose.
>
> **Section 2.02. <u>Dividends</u>.** All dividends declared and paid on the Policy shall be applied as the Trust shall deem appropriate.

Section 6.01 of the split-dollar agreement said that the agreement is to be interpreted such that the only economic benefit is the current life insurance protection. Query whether the IRs and court assumed that this savings clause meant that the dividends could not be paid to the trust – rather that the trust merely had discretion how to apply the dividends to the policy's cash value; I do not recall them addressing the issue. Note that the trust having a right to be receive dividends itself would have violated the Reg. § 1.61-22(c)(1)(ii)(A)(2) rule that the only right to the policy be current life insurance protection and the consequence of violating that rule would have been that the trust would be deemed the owner for gift tax purposes.

Paragraph 2 of the collateral assignment (also not mentioned in the court's opinion) provided as follows:

> 2. It is expressly agreed that the Assignee's interest in the Policy under and by virtue of this Assignment shall be limited to die following specific rights, and no others: (a) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount directly from the Insurer out of the net death proceeds of the Policy; upon the death of the Insured; and (b) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount from the Assignor out of the Policy Cash Value (as defined in the Agreement), in the event the Policy is surrendered or cancelled by the Assignor or m the event the Agreement is terminated during the Insured's lifetime. The Assignee shall have no other rights or powers in and to the Policy as a result of the assignment of the Policy to the Assignee hereunder, and specifically shall not have the right or power to borrow against or obtain loans or advances on the Policy, make withdrawals from the Policy, nor cancel or surrender the Policy.
>
> 3. Except as otherwise provided in this Assignment and the Agreement, the Assignor shall specifically retain all incidents of ownership in and to the Policy, .including, but not limited to: (a) the sole right to cancel or surrender the Policy at any time provided by the terms of the Policy and at such other times as the Insurer may allow; (b) the sole right to collect and receive all distributions or shares of surplus, dividend deposits or additions to the Policy now or hereafter made or apportioned thereto, and to exercise any and all options contained in the Policy with respect thereto; (c) the sole right to exercise all non forfeiture rights permitted by the return of the Policy or allowed by the Insurer and to receive all benefits and advantages derived therefrom; (d) the sole right to designate and change the beneficiary of the Policy (for any amount in excess of the amount to the .Assignee under the Agreement); (e) the sole right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer; and (c) the sole right to collect directly from the Insurer that portion of the net death proceeds of the Policy in excess of those proceeds payable to

Now that we have established that the non-owner receives only the term portion and the owner receives everything else, let's discuss how to treat money received with respect to the subject life insurance contract.

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value or rules apply, if at all, or to the extent that the policy's issuance violates the employer-owned life insurance rules):[4213]

> (i) *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.
>
> (ii) *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

Except for death benefits:[4214]

> Any amount received under a life insurance contract that is part of a split-dollar life insurance arrangement … is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a distribution [from a corporation],[4215] a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

> the Assignee under the Agreement; *provided, however,* in no event shall the Assignor possess the right or power to receive loans or other advances respecting the Policy from the Insurer or any other lender; *provided, further,* all of the foregoing rights retained by the Assignor in the Policy hereunder shall be subject to the terms and conditions of the Agreement.

I view the collateral assignment as being limited by the split-dollar agreement.

Notwithstanding any of the above possible interpretations, I recommend making it clear that the donee is not entitled to dividends. This particular policy was variable life insurance but paid dividends presumably because it was a mutual insurance company.

[4213] Reg. § 1.61-22(f)(3). These exceptions are found in parts II.Q.4.b Transfer for Value Rule; Basis and II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

[4214] Reg. § 1.61-22(e)(1).

[4215] The actual text refers to Code § 301.

The owner is the only party who is credited with "investment in the contract" under Code § 72(e)(6).[4216]

If the employee or donee is provided only current life insurance protection so that a policy owned by the that person for state law purposes is treated as owned by the employer or donor for income tax purposes,[4217] then any modification that causes the employer or donor not to be treated as the donor for income tax purposes has the following consequences:[4218]

(1) If, immediately after such modification, the employer, service recipient, or donor is the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor continues to be treated as the owner of the life insurance contract.

(2) If, immediately after such modification, the employer, service recipient, or donor is not the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor is treated as having made a transfer of the entire life insurance contract to the employee, service provider, or donee under the rules of paragraph (g) of this section as of the date of such modification.

(3) For purposes of this paragraph (c)(1)(ii)(B), entering into a successor split-dollar life insurance arrangement that has the effect of providing any economic benefit in addition to that described in paragraph (d)(3) of this section is treated as a modification of the prior split-dollar life insurance arrangement.

A transfer of the ownership of a life insurance contract (or an undivided interest in such contract) that is part of a split-dollar life insurance arrangement occurs on the date that a non-owner becomes the owner (within the meaning of Reg. § 1.61-22(c)(1)) of the entire contract or of an undivided interest in the contract.[4219] After a transfer of an entire life insurance contract,[4220] the

[4216] Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

[4217] Reg. § 1.61-22(c)(1)(ii)(A), reproduced in the text accompanying fn 4206.

[4218] Reg. § 1.61-22(c)(1)(ii)(B).

[4219] Reg. § 1.61-22(c)(3).

[4220] Reg. § 1.61-22(c)(4), "Undivided interest," provides:

> An undivided interest in a life insurance contract consists of an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract. In the case of any arrangement purporting to create undivided interests where, in substance, the rights, benefits or obligations are shared to any extent among the holders of such interests, the arrangement will be treated as a split-dollar life insurance arrangement.

transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of Reg. § 1.61-22.[4221]

Reg. § 1.61-22(g) provides rules for unwinding the arrangement so that the non-owner becomes the owner. Unwinding the agreement before the insured's death would have the following consequences:

1. <u>If the non-owner buys the policy</u> (outside of an employment setting – see footnote):[4222]

    - The buyer (and the seller for gift tax and employment tax purposes) takes into account the excess of the life insurance contract's fair market value at that time over the sum of:[4223]

        - The amount the buyer pays to the seller; and

        - The amount of all economic benefits (cash value and other policy features other than term insurance protection)[4224] actually taken into account by the buyer (and the seller for gift tax and employment tax purposes), plus certain consideration[4225] paid or treated as having been paid by the buyer for such economic benefits, to the extent that it was not previously applied to such economic benefits.[4226]

      The life insurance contract's fair market value used above is the policy's cash value and the value of all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection; however, a life insurance contract's fair market value for gift tax purposes is determined under Reg. § 25.2512-6(a).

    - Presumably, for income tax purposes the transferor treats the transaction as a sale (to the extent of sale proceeds) or a gift. The transferor's basis would be the fair market value of the split-dollar receivable at the original owner's death plus any premiums paid by the

[4221] Preamble to T.D. 9092, which further explains:

> Thus, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income if the payments are not split-dollar loans under § 1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under § 1.7872-15.

[4222] Reg. § 1.61-22(g)(3) provides:

> *Exception for certain transfers in connection with the performance of services*. To the extent the ownership of a life insurance contract (or undivided interest in such contract) is transferred in connection with the performance of services, paragraph (g)(1) of this section does not apply until such contract (or undivided interest in such contract) is taxable under section 83. For purposes of paragraph (g)(1) of this section, fair market value is determined disregarding any lapse restrictions and at the time the transfer of such contract (or undivided interest in such contract) is taxable under section 83.

[4223] Reg. § 1.61-22(g)(1).

[4224] Referring to benefits described in Reg. § 1.61-22(d)(2)(ii) and (iii), which are reproduced in fn. 4209 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4225] Referring to consideration described in Reg. § 1.61-22(d)(1), which is reproduced in the text following fn 4207 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4226] Referring to accounting for benefits under Reg. § 1.61-22(e)(3)(ii) or (g)(1)(ii).

current owner.[4227] The IRS' position is that any part of the gain attributable to cash value inside the policy is ordinary income and the rest of the gain would be capital gain.[4228]

- After a transfer of an life insurance contract (except when such transfer is in connection with the performance of services and the transfer is not yet taxable under Code § 83), the buyer is treated as the owner of such contract for all purposes.[4229] Furthermore, the buyer's investment in the contract[4230] treats as premiums paid the greater of the fair market value of the contract or certain amounts accounted for under the split-dollar rules.[4231]

[4227] See part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.

[4228] See fn 4142 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance Used in Cross-Purchase Agreements.

[4229] Reg. § 1.61-22(g)(4)(i), which applies to a transfer of an entire policy, referring to Reg. §§ 1.61-22(b) and 1.61-2(d)(2)(ii)(A), and continues:

> After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A).

[4230] For the significance of the "investment in the contract," see part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

[4231] Reg. § 1.61-22(g)(4)(ii), "Investment in the contract after transfer," provides:

> (A) *In general*. The amount treated as consideration paid to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer (or, if later, at the time such transfer is taxable under section 83), equals the greater of the fair market value of the contract or the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section.
>
> (B) *Transfers between a donor and a donee*. In the case of a transfer of a contract between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer, equals the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section except that—
>
> (1) The amount determined under paragraph (g)(1)(i) of this section includes the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor; and
>
> (2) The amount of all economic benefits determined under paragraph (g)(1)(ii) of this section actually taken into account by the transferee does not include such benefits to the extent such benefits were excludable from the transferee's gross income at the time of receipt.
>
> (C) *Transfers of an undivided interest in a contract*. If a portion of a contract is transferred to the transferee, then the amount to be included as consideration paid to acquire the contract is determined by multiplying the amount determined under paragraph (g)(4)(ii)(A) of this section (as modified by paragraph (g)(4)(ii)(B) of this section, if the transfer is between a donor and a donee) by a fraction, the numerator of which is the fair market value of the portion transferred and the denominator of which is the fair market value of the entire contract.
>
> (D) *Example*. The following example illustrates the rules of this paragraph (g)(4)(ii):
>
> (i) In year 1, donor D and donee E enter into a split-dollar life insurance arrangement as defined in paragraph (b)(1) of this section. D is the owner of the life insurance contract under paragraph (c)(1) of this section. The life insurance contract is not a modified endowment contract as defined in section 7702A. In year 5, D gratuitously transfers the contract, within the meaning of paragraph (c)(3) of this section, to E. At the time of the transfer, the fair market value of the contract is $200,000 and D had paid $50,000 in premiums under the arrangement. In addition, by the time of the transfer, E had current access to $80,000 of policy cash value which was excludable from E's gross income under section 102.
>
> (ii) E's investment in the contract is $50,000, consisting of the $50,000 of premiums paid by D. The $80,000 of policy cash value to which E had current access is not included in E's

Generally, the buyer does not get credit toward "investment in the contract" for the economic benefit of any term portion previously taken into account.[4232]

2. <u>If the owner cashes in the policy</u>. The owner reports ordinary income to the extent that the cash received exceeds the premiums paid, without regard to basis, so long as the policy has not been sold (including transfer by pecuniary bequest).[4233]

Reg. § 1.61-22(g), "Examples," provides:

> The following examples illustrate the rules of this section. Except as otherwise provided, each of the examples assumes that the employer (R) is the owner (as defined in paragraph (c)(1) of this section) of a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, that the employee (E) is not provided any economic benefits described in paragraph (d)(2)(iii) of this section, that the life insurance contract is not a modified endowment contract under section 7702A, that the compensation paid to E is reasonable, and that E makes no premium payments. The examples are as follows:
>
> *Example (1)*.
>
> (i) In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under which R will pay all the premiums on the life insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or the policy cash value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E.

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investment in the contract because such amount was excludable from E's gross income when E had current access to that policy cash value.

[4232] Reg. § 1.61-22(g)(4)(ii), "No investment in the contract for current life insurance protection," provides:

> Except as provided in paragraph (g)(4)(ii)(B) of this section, no amount allocable to current life insurance protection provided to the transferee (the cost of which was paid by the transferee or the value of which was provided to the transferee) is treated as consideration paid to acquire the contract under section 72(g)(1) to determine the aggregate premiums paid by the transferee for purposes of determining the transferee's investment in the contract under section 72(e) after the transfer.

The above preceded the 2017 enactment of Code § 1016(a)(1)(B), which is described in the text accompanying fn 4134 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract, which perhaps might affect the regulation's validity? However, the regulation discusses "investment in the contract," whereas the statutory change address basis.

[4233] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured. Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

(ii) Because R is designated as the policy owner of the contract, R is the owner of the contract under paragraph (c)(1)(i) of this section. In addition, R would be treated as the owner of the contract regardless of whether R were designated as the policy owner under paragraph (c)(1)(i) of this section because the split-dollar life insurance arrangement is described in paragraph (c)(1)(ii)(A)(1) of this section. E is a non-owner of the contract. Under the arrangement between R and E, a portion of the death benefit is payable to a beneficiary designated by E. The arrangement is a split-dollar life insurance arrangement under paragraph (b)(1) or (2) of this section. Because R pays all the premiums on the life insurance contract, R provides to E the entire amount of the current life insurance protection E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of current life insurance protection described in paragraph (d)(2)(i) of this section provided to E in each year.

Example (2).

(i) The facts are the same as in Example 1 except that, upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the policy cash value of the contract. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) Because R is designated as the policy owner, R is the owner of the contract under paragraph (c)(1)(i) of this section. E is a non-owner of the contract. For each year that the split-dollar life insurance arrangement is in effect, E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all the premiums on the life insurance contract, R provides to E all the economic benefits that E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section, the value of all economic benefits described in paragraph (d)(2)(i) and (ii) of this section provided to E in each year.

Example (3).

(i) The facts are the same as in Example 1 except that in year 5, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or one-half the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) For each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement during that year. In year 5 (and subsequent years), E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value. Thus, in year 5 (and each subsequent year), E must also include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(ii) of this section provided to E in each year.

(iii) The arrangement is not described in paragraph (c)(1)(ii)(A)(1) of this section after it is modified in year 5. Because R is the designated owner of the life insurance contract, R continues to be treated as the owner of the contract under paragraph (c)(1)(ii)(B)(1) of this section after the arrangement is modified. In addition, because the modification made by R and E in year 5 does not involve the transfer (within the meaning of paragraph (c)(3) of this section) of an undivided interest in the life insurance contract from R to E, the modification is not a transfer for purposes of paragraph (g) of this section.

Example (4).

(i) The facts are the same as in Example 2 except that in year 7, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R will be paid the lesser of 80 percent of the aggregate premiums or the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract.

(ii) Commencing in year 7 (and in each subsequent year), E must include in gross income the economic benefits described in paragraph (d)(2)(ii) of this section as provided in this Example 4(ii) rather than as provided in Example 2(ii). Thus, in year 7 (and in each subsequent year) E must include in gross income under paragraph (d) of this section, the excess of the policy cash value over the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract (to the extent E did not actually include such amounts in gross income for a prior taxable year). In addition, in year 7 (and each subsequent year) E must also include in gross income the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement in each such year.

Example (5).

(i) The facts are the same as in Example 3 except that in year 7, E is designated as the policy owner. At that time, E's rights to the contract are substantially vested as defined in § 1.83-3(b).

(ii) In year 7, R is treated as having made a transfer (within the meaning of paragraph (c)(3) of this section) of the life insurance contract to E. E must include in gross income the amount determined under paragraph (g)(1) of this section.

(iii) After the transfer of the contract to E, E is the owner of the contract and any premium payments by R will be included in E's income under paragraph (b)(5) of this section and § 1.61-2(d)(2)(ii)(A) (unless R's payments are split-dollar loans as defined in § 1.7872-15(b)(1)).

Example (6).

(i) In year 1, E and R enter into a split-dollar life insurance arrangement as defined in paragraph (b)(2) of this section. Under the arrangement, R is required to make annual premium payments of $10,000 and E is required to make annual premium payments of $500. In year 5, a $500 policy owner dividend payable to E is declared by the insurance company. E directs the insurance company to use the $500 as E's premium payment for year 5.

(ii) For each year the arrangement is in effect, E must include in gross income the value of the economic benefits provided during the year, as required by paragraph (d)(2) of this section, over the $500 premium payments paid by E. In year 5, E must also include in gross income as compensation the excess, if any, of the $500 distributed to E from the proceeds of the policy owner dividend over the amount determined under paragraph (e)(3)(ii) of this section.

(iii) R must include in income the premiums paid by E during the years the split-dollar life insurance arrangement is in effect, including the $500 of the premium E paid in year 5 with proceeds of the policy owner dividend. R's investment in the contract is increased in an amount equal to the premiums paid by E, including the $500 of the premium paid by E in year 5 from the proceeds of the policy owner dividend. In year 5, R is treated as receiving a $500 distribution under the contract, which is taxed pursuant to section 72.

Example (7).

(i) The facts are the same as in Example 2 except that in year 10, E withdraws $100,000 from the cash value of the contract.

(ii) In year 10, R is treated as receiving a $100,000 distribution from the insurance company. This amount is treated as an amount received by R under the contract and taxed pursuant to section 72. This amount reduces R's investment in the contract under section 72(e). R is treated as paying the $100,000 to E as cash compensation, and E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

Example (8).

(i) The facts are the same as in Example 7 except E receives the proceeds of a $100,000 specified policy loan directly from the insurance company.

(ii) The transfer of the proceeds of the specified policy loan to E is treated as a loan by the insurance company to R. Under the rules of section 72(e), the $100,000 loan is not included in R's income and does not reduce R's investment in the contract. R is treated as paying the $100,000 of loan proceeds to E as cash compensation. E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

II.Q.4.f.iii. Split-Dollar Loans under Reg. § 1.7872-15

For purposes of Reg. § 1.7872-15, "split-dollar life insurance arrangement," "owner," and "non-owner" have the same meanings as provided in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.[4234]

Reg. § 1.7872-15(a)(2) provides:[4235]

(i) *General rule*. A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable*. For purposes of § 1.61-22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans*. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples*. The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example (1). Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example (2).

(i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The

[4234] Reg. § 1.7872-15(b), referring to Reg. § 1.61-22(b) and (c).

[4235] Reg. § 1.7872-15(a)(1) provides, "This section applies to split-dollar loans as defined in paragraph (b)(1) of this section." Reg. § 1.7872-15(b)(1) provides, "A split-dollar loan is a loan described in paragraph (a)(2)(i) of this section." Thus, Reg. § 1.7872-15(a)(2)(i) is our starting point.

employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61-22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61-22(b)(5).

Reg. § 1.7872-15(a)(1) provides:

> If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61-22.

The OID rules referred to above provide that, if adequate stated interest is not paid annually, payments will be deemed made from the borrower to the lender each year, generating interest income[4236] and generally nondeductible interest,[4237] even though no cash changes hands.[4238] If the split-dollar agreement is between a donor and a donee, consider making the donee be an

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[4236] Code § 1272.

[4237] Reg. § 1.7872-15(c) provides:

> *Interest deductions for split-dollar loans*. The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. See sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

[4238] Reg. § 1.7872-15(f), "Treatment of stated interest and OID for split-dollar loans," provides:

> (1) *In general*. If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in § 1.1273-1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). See § 1.446-2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under § 1.1272-1 for any OID on a split-dollar loan. However, § 1.1272-1(c) does not apply to any split-dollar loan. See paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.
>
> (2) *Term, payment schedule, and yield*. The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

irrevocable grantor trust, so that no interest income is recognized while the trust is deemed owned by the donor.[4239] Presumably any accrued interest at the time that grantor trust treatment is turned off will be considered principal for income tax purposes; perhaps the promissory note might be drafted so that any accrued but unpaid interest is added to principal on the note's anniversary to further support that treatment.

Generally, a split-dollar loan will bear and <u>accrue</u> interest at the long-term applicable federal rate, so that making the loan does not constitute a gift in a donor-donee setting or compensation in an employer-employee setting. This accrued interest can be ignored for two reasons (in addition to possibly being ignored under general tax principals. First, Reg. § 1.7872-15(a)(4), "Certain interest provisions disregarded," provides:

(i) *In general*. If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples*. The provisions of this paragraph (a)(4) are illustrated by the following examples:

Example (1).

(i) On January 1, 2009, Employee B issues a split-dollar term loan to Employer Y. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, B and Y also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, B's requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example (2).

(i) On January 1, 2004, Employee B and Employer Y enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B equal to B's salary in the three years preceding the retirement of B. On January 1, 2009, B and Y enter into a split-dollar life insurance arrangement and, under the arrangement, B issues a split-dollar term loan to Y on that date . The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of B's non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to B's

[4239] Rev. Rul. 85-13, referred to in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to B's requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by Y of non-qualified deferred compensation is independent from B's requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause B's requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan that provides for stated interest of five percent, compounded annually.

Thus, one should avoid bequeathing the split-dollar note receivable until long after the funds are advanced.[4240]

Second, interest (or any other payment) needs to be reasonably expected to be repaid or must be deemed expected to be repaid. As mentioned above,[4241] to be a split-dollar loan, among other requirements the payment of premiums must be "a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest)." Split-dollar loans are commonly nonrecourse, and if the policy does not perform then typically the lender eats the loss. Reg. § 1.7872-15(d), (j) discuss nonrecourse or contingent payments.[4242]

Reg. § 1.7872-15(j) controls over the usual rules governing contingent payments in making loans at the applicable federal rate (AFR).[4243] The lender puts together a projected payment schedule, which everyone directly or indirectly involved in the loan must use.[4244] The term of a split-dollar loan payable on the death of an individual is the individual's life expectancy as determined under the appropriate table in Reg. § 1.72-9 on the day the loan is made;[4245] if the insured outlives his

[4240] See text accompanying fns 4266-4267 in part II.Q.4.f.iv.(b) Loan Regime After Initial Owner Has Died.
[4241] Reg. § 1.7872-15(a)(2)(i)(B), quoted in full in the text accompanying fn 4235.
[4242] Reg. § 1.7872-15(d)(1) provides:

(1) *In general*. Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. See paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

[4243] Reg. § 1.7872-15(j)(1) provides:

(1) *In general*. Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

[4244] Reg. § 1.7872-15(j)(3)(ii)(E) provides:

Borrower/lender consistency. Contrary to § 1.1275-4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

[4245] Reg. § 1.7872-15(e)(5)(ii)(C), which further provides:

If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

or her life expectancy, the split-dollar loan is treated as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date.[4246] Although a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes unless the parties to the arrangement make the written representation provided for in Reg. § 1.7872-15(d)(2).[4247] Treating a nonrecourse payment as contingent may cause that payment to assigned a zero value,[4248] which would mean that the usual nonrecourse split dollar loan would be assigned a zero value.

Thus, the written representation provided for in Reg. § 1.7872-15(d)(2) is critically important in making sure that a nonrecourse loan is respected. An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not deemed a contingent payment if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.[4249] Unless the IRS provides otherwise, "both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement."[4250] If the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan according to the

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If the split-dollar loan is payable on the later of the individual's death or a term certain, the term certain is used. Reg. § 1.7872-15(e)(5)(v)(A), (B)(2).

The contingent payment rules look to the above regulations. Reg. § 1.7872-15(j)(3)(ii)(B) provides:

> *Split-dollar term loans payable upon the death of an individual*. If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(1) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(2) of this section, whichever is applicable.

Closing the loop, Reg. § 1.7872-15(e)(5)(ii)(A) provides:

> *Applicability*. This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

[4246] Reg. § 1.7872-15(e)(5)(ii)(D), which further provides:

> However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

[4247] Reg. § 1.7872-15(j)(2)(ii).

[4248] When the lender determines the projected payment schedule, Reg. § 1.7872-15(j)(3)(ii)(A) provides:

> The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

[4249] Reg. § 1.7872-15(d)(2)(i).

[4250] Reg. § 1.7872-15(d)(2)(ii), which further provides:

> This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

Letter Ruling 201041006, summarizing the deadline as well as the issue and then granted relief.

representation, "the excess of the interest required to be accrued over the interest actually paid is treated as waived, cancelled, or forgiven by the lender."[4251]

Once we have figured out the payment schedule that the IRS will respect, Reg. § 1.7872-15(k) applies a payment made by the borrower on all direct and indirect split-dollar loans in the following order:

> (1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;
>
> (2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;
>
> (3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and
>
> (4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under ... (1), (2), and (3) ….

Reg. § 1.7872-15(m) describes what happens when the insurance company pays the lender:

> *Repayments received by a lender*. Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

II.Q.4.f.iv. Income Taxation of Split-Dollar Agreement After Premium Payor Dies When Life Insurance Not on the Owner's Life

When the premium payor dies holding a split-dollar receivable on the payor's life, the receivable is repaid immediately and correspondingly has a basis equal to the amount of the receivable, generating no income taxation.

However, if the split-dollar receivable is not on the premium payor's life, the receivable would be valued based on when the receivable is collected. The split-dollar arrangement's long-term nature may cause the receivable to be valued at significantly less than its face amount, leading to a step-down in basis; see the cases in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

The rest of this discussion, from part II.Q.4.f.iv, assumes that the initial owner has died and refers to the successor owner as the owner.

[4251] Reg, § 1.7872-15(h)(1)(iv).

II.Q.4.f.iv.(a). Economic Benefit Model After Initial Owner Has Died

In the economic benefit model described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22, the economic benefit of current life insurance protection is considered a payment from the owner to the non-owner.[4252] The payment's nature depends on the relationship between the owner and non-owner.[4253] As the insured gets older, the amount of this payment increases and may become exorbitant, and the arrangement might need to be terminated. If the insurance company distributes the cash value, the holder of the split-dollar receivable recognizes ordinary income to the extent that the amount received exceeds the holder's "investment in the contract," the latter which is described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy). Under those rules, the change in basis by reason of death does not affect the "investment in the contract." If the policy's ownership is considered transferred from the owner to the non-owner, then the transfer may be a sale (taxable to the extent that proceeds exceed basis), a gift, a distribution, or some other appropriate arrangement.[4254] An advantage of just cashing out the policy with the insurance company is that the investment in the contract, which would generally exceed the stepped-down basis on the date of the original owner's death, would reduce income relative to the gain on sale, which the IRS would assert (not necessarily successfully)[4255] is ordinary income anyway.

If the arrangement stays in place until the insured's death, then:

- Generally, the owner's death benefit is nontaxable under Code § 101(a).[4256]

- Generally, the non-owner's death benefit is nontaxable under Code § 101(a), if the non-owner paid for or properly took into account the value of the economic benefit of the life insurance protection.[4257]

[4252] Reg. § 1.61-22(d)(1), quoted in the text following fn 4207 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4253] The part of § 1.61-22(d)(1) that follows fn 4207 in part 1.61-22(d)(1) provides:

> Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

[4254] See fns 4214 and 4222-4228 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4255] See fn 4155 in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[4256] Reg. § 1.61-22(f)(3)(ii) provides:

> *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

[4257] Reg. § 1.61-22(f)(3)(i) provides:

- Generally, any death benefit not described above is taxable.[4258]

If the insured was employed by or owned at least 5% of the original owner when the policy was issued, special requirements apply to obtain the Code § 101(a) exclusion. See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Also, to obtain the Code § 101(a) exclusion, any transfer from the original owner to a successor owner needs to qualify for an exception from the transfer-for-value rules,[4259] which means that any distribution from a trust or estate should be pick-and-choose fractional instead of pecuniary.[4260]

II.Q.4.f.iv.(b). Loan Regime After Initial Owner Has Died

Suppose a $1 million split-dollar loan under Code § 1.7872-15 is worth $150,000 at the death of the owner who is not the insured. This valuation spread is realistic, because commercial lenders do not make long-term loans except for real estate, and even then they tend to require significant equity. Unlike other loans, payment of annual interest is not required in a split-dollar loan.[4261] A split-dollar loan does not require any equity, and the lender cannot accelerate the loan if the underlying collateral starts to lose value or otherwise fail to perform. Furthermore, a cash value life insurance policy loses value immediately, due to commissions and other start-up costs the insurance company incurs that are allocated to the policy. Commercial lenders who finance life insurance tend to require some combination of equity or outside collateral, use floating interest rates, and impose loan maturities much shorter than the insured's life expectancy.

Let's look at the character of the note repayment:

- Any payment from the life insurer to repay the note is treated as a payment from the insurer to the borrower and then from the borrower to the lender.[4262]

- To the extent of any accrued interest, the payment would have that character.[4263]

> *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

[4258] Reg. § 1.61-22(f)(3)(iii) provides:

> *Transfers of death benefit proceeds*. Death benefit proceeds paid to a party to a split-dollar life insurance arrangement (or the estate or beneficiary of that party) that are not excludable from that party's income under section 101(a) to the extent provided in paragraph (f)(3)(i) or (ii) of this section, are treated as transferred to that party in a separate transaction. The death benefit proceeds treated as so transferred will be taxed in a manner similar to other transfers. For example, if death benefit proceeds paid to an employee, the employee's estate, or the employee's beneficiary are not excludable from the employee's gross income under section 101(a) to the extent provided in paragraph (f)(3)(i) of this section, then such payment is treated as a payment of compensation by the employer to the employee.

[4259] See part II.Q.4.b Transfer for Value Rule; Basis.

[4260] See part II.J.8.d Distribution in Kind; Specific Bequests.

[4261] See part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns 4187-4188.

[4262] See Reg. § 1.7872-15(m), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4263] See Reg. § 1.7872-15(k), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15, provides that accrued interest is deemed paid first.

- To the extent that a payment is principal and the payment exceeds basis, the payment would probably be taxed as capital gain to the original holder of the note or to a substituted basis transferee or ordinary income for any other holder.[4264] Thus, if the decedent's estate is considered to be the issuer, then the estate and any beneficiary (except the recipient of a pecuniary bequest) should have capital gain. Otherwise, the gain would be taxed as ordinary income.

Many commentators have suggested that, because one misstep can cause the economic benefit split-dollar regime (described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**) to be unwound, resulting in potentially huge income and gift tax consequences, the loan regime is safer.[4265] However, consider *Morrissette*, in which the split-dollar receivable's owner bequeathed the receivable to the split-dollar obligor.[4266] If the arrangement had been a split-dollar loan, that bequest might have violated Reg. § 1.7872-15(a)(4) (especially Example (1)), causing the interest expected to be paid under the loan to be disregarded, eviscerating most of the loan's value for gift tax purposes.[4267]

On the other hand, the economic benefit regime would let the successor owner cash in the policy using the investment in the contract (generally premiums paid) instead of the basis that was greatly reduced when the original owner died.[4268] Furthermore, if the insured dies before the economic benefit regime is unwound and the transfer-for-value and related rules have not been violated, all benefits to everyone are received tax-free.[4269]

II.Q.4.f.v. Estate Tax Consequences of Split-Dollar Agreements

The split-dollar economic benefit regime regulations do not apply for estate tax purposes.[4270]

Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[4271] held that a taxpayer's entering into a heavily discounted generational split-dollar agreement[4272] did not

[4264] See fns 2075-2076 (especially the latter) in part II.H.5.b Moving Real Estate or Other Low-Basis Property from Irrevocable Trust to Grantor, discussing what if an irrevocable grantor trust sold assets to the decedent in exchange for a note from the decedent.

[4265] See fns 4209-4212 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4266] See fns 4271-4274 in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

[4267] Reg. § 1.7872-15(a)(4) is reproduced in full in text preceding the sentence that includes fn 4240 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4268] See text accompanying fns 4254-4255 in part II.Q.4.f.iv.(a) Economic Benefit Model After Initial Owner Has Died.

[4269] See fn 4213 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4270] See fn 4202 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4271] 146 T.C. 171 (2016). For a complete discussion, see S. Gorin & H. Zaritsky, Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements, 28 Probate Practice Reporter 1 (June 2016). For a link to various selected documents filed with the Tax Court, including the split dollar agreement and appraisal the IRS viewed as representative of the arrangements, see http://tcinstitute.com/rv/ff002894cb41394cda173f9fe7469759eae604bd. In *Estate of Levine v. Commissioner*, Tax Court docket no. 9345-15, a July 13, 2016 order granted summary judgment to the taxpayer because the parties agreed that *Morrissette* controlled, with the IRS preserving its right to appeal, indicating that it continued to disagree with *Morrissette*.

[4272] Under the split-dollar rules, the decedent was the deemed owner of policies on younger insureds. Such an arrangement is referred to as generational because the insured is expected to outlive the decedent by a significant number of years. That the decedent's estate has to wait for many years to collect what it is constitute a gift, even though the decedent bequeathed her interest to the other party in the split-dollar arrangement.[4273] In that case, the mother funded life insurance owned by irrevocable life insurance trusts ("ILITs") to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother's estate tax return reported that her right to receive the almost $30 million she invested was worth only approximately $7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the other party the agreement,

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owed and must also continue to expend funds during that time might cause the value of the decedent's economic rights to be discounted. However, the decedent's estate would benefit from the growth in the policy's cash value and would not bear the mortality charge (except to the extent that the mortality charge exceeded the rates under the IRS' Table 2001 rates), so it is unclear how much the policy should be discounted.

[4273] The IRS apparently argued that bequeathing the decedent's split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

> Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust's interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, because the CMM Trust was a revocable trust with respect to Mrs. Morrissette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrissette retained the right to receipt of the receivables.

The decedent's ability to amend her revocable trust was pure legal fiction, which legal fiction this case takes to the extreme. From the finding of facts:

> [The decedent's sons] Arthur, Donald, and Kenneth petitioned the Circuit Court of Fairfax County, Virginia (Fairfax court) for appointment of a conservator for Mrs. Morrissette's estate and asked the conservator to transfer additional assets to the CMM Trust. On August 18, 2006, the court found Mrs. Morrissette to be permanently incapacitated and appointed Cathleen A. Hatfield, an employee of the Interstate Group, to serve as the conservator. The Fairfax court granted Ms. Hatfield broad authority to act on Mrs. Morrissette's behalf. The conservatorship expired on October 20, 2006.

The conservator did the following during that 2-month period:

1. Established Dynasty Trusts,
2. Amended the revocable trust to authorize entering into the split-dollar agreements and bequeathing the revocable trust's interest in each split-dollar agreement to the other party to the split-dollar agreement, and
3. Entered into a buy-sell agreement requiring the life insurance.

Then, the Dynasty Trusts bought the policies and, together with the revocable trust (of which the sons were co-trustees), entered into the split-dollar agreements.

The idea that this arrangement would ever be modified was ludicrous, given that the sons orchestrated this entire transaction for their benefit, using as the conservator an employee of the company that they directly or beneficially owned, to set up a multi-million dollar transaction in a compressed period of time.

The following facts might have helped the estate's case:

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court's mind - see fn 95 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders] – to fund a buy-sell agreement.
- The donor lived 4 years after the arrangement was made.
- The gift tax returns used the IRS' Table 2001 rates instead of any alternative term rates provided by the insurance company.

the mother might have prevented that result.[4274] However, in a similar situation, *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, held that Code §§ 2036, 2038, and 2703[4275] may very well apply, probably not qualifying for the exception for a sale for adequate and full consideration that would prevent the former two[4276] from applying because the split dollar receivable was only a small fraction of the amount of money the decedent contributed to the agreement.[4277] The court failed to address Reg. § 20.2038-1(a)(2), which prevents Code § 2038 from applying "if the

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[4274] Presumably the bequest of the receivable or even a note under the loan regime would not generate income tax. Bequeathing a note (other than a note received in an installment sale) does not trigger cancellation of indebtedness income to the debtor; see fn. 6781, found in part III.B.5.b Promissory Notes. However, if *Morrissette* had used the loan regime, bequeathing the note may have caused the loan to be disregarded for gift tax purposes, which would have made the whole amount advanced constitute a gift. See fn 4240 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4275] The court held:

> On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value. The estate claims that decedent paid $10 million to the insurance companies for the benefit of MB Trust and in return received certain rights, namely, the termination rights (which the estate claims are worthless) and decedent's death benefit rights (which, according to the estate's valuation theory, are worth less than 2% of the cash surrender value). MB Trust, meanwhile, paid nothing into this arrangement and received MB Trust's death benefit rights. As best we understand the estate's valuation theory, MB Trust's death benefit rights are allegedly worth at least the cash surrender value minus the value of decedent's death benefit rights (*i.e.*, $9,611,624 – (allegedly) $183,700 = $9,427,924). Nothing in the parties' filings suggests that MB Trust ever paid, or was obligated to pay, any interest or other amount to compensate decedent for MB Trust's acquisition and use of this amount….
>
> Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreements and withdraw his investment from these arrangements.

[4276] The court held:

> … the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1).

[4277] The court noted:

> Whether a transfer was for adequate and full consideration is a question of value; *i.e.*, did what decedent transferred roughly equal the value of what he received in return? See, *e.g.*, *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278. On the basis of the undisputed facts presently before us, we conclude that it was not.
>
> According to the estate, at decedent's date of death MB Trust's ability to veto decedent's termination of the agreements rendered the termination rights valueless. Additionally, the estate alleges that decedent's death benefit rights are worth less than 2% of the cash surrender value (i.e., $183,700 ÷ $9,611,624 < 2%). But MB Trust's veto power existed from the moment decedent entered into these split-dollar agreements, and nothing in the undisputed facts presently before us suggests that the terms of the split-dollar agreements were altered between execution of the agreements and decedent's date of death; consequently, this alleged 98% discount must have been present from the execution of these agreements. Therefore, *according to the estate's valuation theory*, the initial transfer of $10 million in value cannot have been in exchange for property worth that amount; *i.e.*, under the estate's argument, what decedent received was necessarily worth at least 98% less than what he transferred (even without taking into account the amounts used to pay commissions and fees to the insurance company). Consequently, at least according to the estate's valuation theory, the value of what decedent received (allegedly, something close to $183,700) was not even roughly equal to the $10 million decedent paid.

decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law."[4278] On December 12, 2018, the parties settled the case, with the estate paying $2,123,508 in estate tax and $424,702 in Code § 6662(h) penalties (but no Code § 6662(a) penalties).

In an order entered June 21, 2018, the *Morrissette* Tax Court denied the taxpayer's motion for partial summary judgment on grounds similar to *Cahill*.[4279] On February 19, 2019, the court

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[4278] That exception is an alternative to the exception to which the court alluded, Reg. § 20.2038-1(a)(1), which prevents Code § 2038 from applying, "to the extent that the transfer was for an adequate and full consideration in money or money's worth (see §20.2043-1)."

[4279] The court reasoned and ruled (Docket No. 4415-14):

> Petitioners argue that the decedent's only right under the split-dollar arrangements was the death benefit and that right was without restriction. They argue that the property being valued is the death benefit, the death benefit is free of any restriction as defined in section 2703(a)(2), and accordingly section 2703(a) does not apply to the valuation of the split-dollar arrangements. They argue that the split-dollar arrangements did not contain any restrictions on the decedent's rights for purposes of section 2703(a)(2). They state, without further analysis, that the termination restriction, *i.e.*, that neither party had the unilateral right to terminate the split-dollar arrangements, is not a restriction for purposes of section 2703(a)(2).
>
> Respondent argues that the decedent's rights also include the termination right and receipt of a payout upon termination. He argues that the termination right were restricted by the split-dollar arrangements and that section 2703(a)(2) applies to disregard the termination restrictions. He also argues the decedent had rights under collateral assignment agreements. He contends that the CMM Trust and the Dynasty Trusts entered into agreements in which the Dynasty Trusts assigned the insurance policies to the CMM Trust as collateral for its $30 million premium prepayment, and the collateral assignments contained a restriction that should be disregarded under section 2703(a)(2). He argues that neither the termination restriction nor the collateral assignment restriction is inherent or necessary to a split-dollar agreement. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 488-489 (2000), *aff'd* in part, *rev'd* on another issue, 293 F.3d 279 (5th Cir. 2002) (holding that section 2703 did not apply to disregard partnership entity to cause partnership assets to be included in the estate); *cf. Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013), *aff'd* in part, *rev'd* in part, 767 F.3d 443 (5th Cir. 2014) (applying section 2703(a) to disregard restriction on decedent's right to institute a partition action for undivided fractional interests in art work); *Holman v. Commissioner*, 130 T.C. 170 (2008) (applying section 2703 to disregard restrictions in partnership agreement on partner's right to transfer her partnership interest). He argues that we should deny summary judgment in petitioners' favor because genuine issues of material fact exist. He argues that the Court should find that section 2703 applies to the decedent's rights under the split-dollar arrangements as a matter of law, but he did not file a cross-motion for summary judgment on this issue. If section 2703 applies, respondent argues that we should disregard the termination restrictions pursuant to section 2703 and value the decedent's rights under the split-dollar arrangement as if she had the right to unilaterally terminate the agreements. He does not seek to disregard the split dollar arrangements in their entirety.
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> The restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2). *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, at *23-28. In *Estate of Cahill*, we denied the estate's motion for partial summary judgment that section 2703(a) is inapplicable to split-dollar arrangements with termination restrictions similar to those at issue here where the parties to the arrangements could mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. *Id.* Here the CMM Trust and the respective Dynasty Trust could mutually agree to terminate the split-dollar arrangement, but neither party could unilaterally terminate the agreement. Respondent has asserted alternative arguments that the split-dollar arrangements are includible in the decedent's gross estate pursuant to sections 2036 and 2038 relating to inter vivos transfers, which petitioners have not been addressed

denied the IRS motion for summary judgment under Code §§ 2036(a)(2) and 2038(a)(1) and (2), finding that "there is a material factual dispute concerning the issue of full and adequate consideration" and denied the IRS motion for summary judgment under Code § 2703, stating that Code § 2703 "will apply unless the requirements of the section 2703(b) exception are satisfied" but that "there is a genuine dispute of material fact of whether the transfers were a device to transfer property to members of decedent's family for less than full an adequate consideration in money or money's worth." The case is set for trial October 7-10, 2019.

Also consider potential estate tax inclusion when the insured controls an employer that is a party to the split-dollar agreement. Because part of the death benefit is not payable to the employer,[4280] the IRS might argue that the insured has incidents of ownership over the policy that is subjected to the split-dollar arrangement. To avoid such an argument, the split-dollar agreement and any collateral assignments might limit the employer's rights to just those provided in the split-dollar agreement.[4281] Although that approach would work for the split-dollar loan regime, it might not

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> in their summary judgment motions and remain at issue for trial. See *Estate of Cahill v Commissioner*, T.C. Memo. 2018-84, at *15-*16 (holding the estate retained rights under the split-dollar arrangements as defined in sections 2036(a) and 2038(a) and denying summary judgment to the estate that those sections are inapplicable). As there may be facts or theories not yet presented, we decline to treat respondent's response to petitioners' motion for partial summary judgment as a cross-motion for partial summary judgment.
>
> Accordingly, it is ORDERED that petitioners' motion for partial summary judgment, filed December 5, 2016, relating to the issue of the applicability of section 2703 is denied.

[4280] If all of the death benefit is payable to the employer or used for the employer's business purpose, the insurance policy is not included in the insured's estate by reasons of incidents of ownership, although the death benefit might very well affect the employer's value that is included in its deceased owner's estate. See part II.Q.4.a Funding the Buy-Sell, especially fn. 4047.

[4281] For example, Letter Ruling 9651017 held:

> Under the split-dollar agreement in the present case, X is expressly prohibited from borrowing against any part of the policy. In addition, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the trustee of Trust. Accordingly, we conclude, that X will possess no incidents of ownership in the policy acquired by the Trust. See Rev. Rul. 76-274, 1976-2 C.B. 278, modified by Rev. Rul. 82-145, 1982-2 C.B. 213.

Letter Ruling 9651030 had the same or similar language. Letter Ruling 9511046 elaborated:

> Under the split-dollar agreement in the present case, the corporation will, however, hold no incidents of ownership. The corporation will have no defacto ability to force the trustee to borrow against the policy because the corporation is required to make the necessary premium payments for the duration of the trust. The power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the third party trustee of the irrevocable trust and are not attributable to the corporation. Accordingly, although the surviving spouse will hold control of the corporation for purposes of section 20.2042-1(c)(6), the corporation will hold no incidents of ownership in the second-to-die life insurance policy, and, thus, no incidents of ownership in the policy will be attributable to the surviving spouse.

Letter Ruling 9348009 held:

> The facts in this case indicate that the Company's economic interest in the policy is limited to that of irrevocably designated beneficiary of that portion of the proceeds that is equal to the cash surrender of the policy. Additionally, we assume that no agreement or other factors exist that would cause the value of the decedent's stock holdings in the corporation not to be taken into account for purposes of section 2031. Under these circumstance, because the Company possesses no rights

work so well for the economic benefit regime. The economic benefit regime provides that the non-owner is deemed to have current access to that portion of the policy cash value to which the non-owner has a current or future right and that currently is inaccessible to the owner.[4282] In other words, if the employer is generally the deemed owner but cannot access the cash value, the other party to the split-dollar agreement is deemed to benefit from that cash value if the other party has a current or future right to part of the cash value. Thus, the approach suggested in fn. 4281 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the employer or through sharing the premium. However, *Morrissette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 4271.

For donor-donee arrangements on the life of the insured, naming the donor as owner is not available. If the donor is the insured, one must draw up an absolutely tightly woven split-dollar agreement preventing the donor from having incidents of ownership, if using the economic regime (as in fn. 4271); those who are risk averse should use the loan regime. If the donor is not the insured, preventing the donor from having incidents of ownership is not important; one can then either name the donor as owner to take a conservative approach or, using a tightly woven split-dollar to try to secure valuation discounts,[4283] name the donee as the owner.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[4284]

1. Clearly state that the purpose of the split dollar agreement is to "fund a permanent life insurance policy for estate liquidity or business succession, for example."

2. Add a preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg. § 1.61-22 and that the ONLY benefit intended to be provided to the "donee" trust is life insurance protection.

3. Do NOT give the donee trust the right to borrow against the cash value.

4. At termination or death, make sure that the donor gets the GREATER of cash value or premiums paid.

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the exercise of which would impact that portion of the proceeds payable to a beneficiary other than the Company, the Company cannot be said to possess any incidents of ownership in the policy of the type that would be attributable to the surviving spouse under section 20.2042-1(6) of the regulations.

[4282] Reg. § 1.61-22(d)(2)(ii) - see fns. 4209 and 4211 for text of the relevant regulations.

[4283] See fns. 4271-4273.

[4284] A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).

5. The donor should be REQUIRED to pay all premiums. The donee has no obligation to pay premiums. If premiums are prepaid, there will be no additional benefit to the donee trust.

6. Do not mention the disposition of the receivable at death. Otherwise, it might be construed as an additional benefit to the donee trust.

II.Q.4.g. Income Tax Trap for Business-Owned Life Insurance

II.Q.4.g.i. Analysis of Code § 101(j)

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.[4285] An "employer-owned life insurance contract" (a term that applies to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[4286]

An "employer-owned life insurance contract" is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person (or certain related party) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.[4287] An "applicable policyholder" means, with respect to any employer-owned life insurance contract, the person described in the preceding sentence who owns the contract[4288] at the time it is issued.[4289]

"Employee" includes a "highly compensated employee" under Code § 414(q), [4290] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[4291] Thus, an owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.[4292]

[4285] Code § 101(j).
[4286] Code § 101(j)(1), (2).
[4287] Code § 101(j)(3)(A).
[4288] Code § 101(j)(3)(B)(i).
[4289] The qualification at the time it is issued is not mentioned in any particular authority but appears to be implicit in the statutory scheme. See the text accompanying fn. 4294.
[4290] Code § 101(j)(5).
[4291] Code § 414(q)(1), "In general," provides:

> The term "highly compensated employee" means any employee who -
> (A) was a 5-percent owner at any time during the year or the preceding year, or
> (B) for the preceding year -
> (i) had compensation from the employer in excess of $80,000, and
> (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.
>
> The Secretary shall adjust the $80,000 amount under subparagraph (B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

Notice 2018-83 provides that the $80,000 amount is $125,000 for 2019.
[4292] Notice 2009-48, A-8 provides:

> Section 101(j)(4) provides no exception that would excuse a wholly-owned corporation and its employee-owner from the notice and consent requirements that otherwise apply, nor can actual knowledge alone substitute for the statutory requirement that notice and consent be 'written.' Moreover, the requirement that notice and consent be written avoids factual controversies that otherwise could result where, for example, the sole owner of a corporation delegates financial matters to an employee.

The notice and consent requirements are met if, before the issuance of the contract, the employee (A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued, (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.[4293] The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, "applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[4294]

In addition to the notice and consent requirements, either the insured must have a qualifying relationship with the company or the death benefit must be put to certain uses:

- A qualifying relationship includes the insured being an employee, director, or 5% owner at any time during the 12-month period before the insured's death.[4295]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[4296] (Note that Code § 101(j) does not apply unless the insured is an employee with respect to the trade or business of the applicable policyholder when the contract is issued, so the concern for the qualifying relationship or qualifying use applies only when the insured is an employee who does not satisfy this bullet point when the contract is issued.)[4297]

- A qualifying use is being paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured.[4298]

- Another qualifying use is the purchase of an equity (or capital or profits) interest in the applicable policyholder from any person described in the preceding bullet point.[4299] Beware of the proceeds exceeding this use.

[4293] Code § 101(j)(4).
[4294] Notice 2009-48, A-1, further below, clarifies that the person to whom this sentence refers generally is the entity that employs the insured rather than an owner of the entity and that the entity is treated as owning a policy owned by a grantor trust with respect to which the entity is the deemed owner.
[4295] Code § 101(j)(2)(A)(i). The reference to director comes from Code § 101(j)(5), and a 5% owner is described in the text accompanying fns. 4290-4292.
[4296] Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 4290-4292. The highly compensated employees are those described in Code § 414(q) (without regard to Code § 414(q)(1)(B)(ii)) or Code § 105(h)(5) (except that 35% is substituted for "25 percent" in Code § 105(h)(5)(C). Code § 414(q)(1) is reproduced in fn 4291 in part II.Q.4.g.i Analysis of Code § 101(j).
[4297] See text accompanying fns. 4287-4289.
[4298] Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).
[4299] Code § 101(j)(2)(B)(ii).

A life insurance-funded buy-sell agreement might be structured to comply with these rules, in case the parties forget to do the required notice and consent.[4300] It also would guard against error in my suggestion that "applicable policyholder" is limited to being the person to whom the policy is issued when the insured is an "employee" of that person.

These rules impose various notice and other requirements that in most cases will not be a practical obstacle to implementing buy-sell agreements if signed <u>before</u> the application is signed.[4301] The employer might be able to cure a failure before the due date of its return for the year in which the policy was issued if the insured has not died yet.[4302] Another cure would be to transfer the policy to the insured, then the insured transfers the policy back to the company (generally, transfers from the insured to the company are not subject to the rule, except with respect to increases in coverage);[4303] step transaction concerns might suggest that the insured

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[4300] One might consider provisions such as that found in part II.Q.4.g.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

> … the Agreement provides that Taxpayer will obtain life insurance on the life of each Shareholder, and that Taxpayer will be the owner and beneficiary of such life insurance. If the Agreement is terminated, or a Shareholder disposes of his interest in Taxpayer as allowed by the Agreement, a Shareholder has the right to purchase from Taxpayer any Taxpayer-owned life insurance covering his life. If the life insurance was not purchased, Taxpayer retained the right to surrender or otherwise dispose of the life insurance.

The ruling concluded:

> …considering all of Taxpayer's documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:
>
> a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder's life;
> b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
> c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;
> d) by signing the Agreement, each Shareholder consented that such coverage may continue after the Shareholder terminates employment; and
> e) through the Agreement and the Application, each Shareholder was informed in writing that Taxpayer will be a beneficiary of any proceeds payable upon the death of the Shareholder.

[4301] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[4302] Notice 2009-48, A-13 provides:

> Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met: (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees; (2) the failure to satisfy the requirements was inadvertent; and (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

[4303] Notice 2009-48, Q/A-8 provides:

> Q-8. Is notice and consent required with regard to an existing life insurance contract that an employee irrevocably transfers to an employer?

transfer the policy into a life insurance LLC[4304] instead of waiting long enough (whatever that means) to avoid an assertion of the step transaction doctrine.

The proposed policy owner should obtain the insured's written consent before the life insurance application is signed.

Consider having the maximum face amount in that consent provide a cushion in excess of the largest amount that the parties can conceive of that death benefit being (including increased death benefits due to investing the cash value very successfully).

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually misunderstand) these rules. Accordingly, tax advisors should consider warning their clients that the tax advisors need to be involved <u>before</u> any policy is issued.

Every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006 is required to file IRS Form 8925 each year.[4305] "Applicable policyholder" and "employer-owned life insurance contract" are defined for purposes of this reporting rule the same way they are for determining whether a policy is subject to the notice and consent rules.[4306]

A-8. No. The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death. In the event the employer subsequently increases the face amount of the contract, however, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.

[4304] See part II.Q.4.i Life Insurance LLC.

[4305] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[4306] Code § 6039I(c).

These rules for life insurance contracts issued or materially changed after August 17, 2006.[4307] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[4308] including guidance on tax-free exchanges.[4309]

As to buy-sell agreements, Notice 2009-48 provides that a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner – in other words, a cross-purchase - is not subject to these rules.[4310] However, if the business owns it,[4311] the following rules apply (emphasis added):[4312]

> **Exceptions to the Application of § 101(j)(1)**
>
> Section 101(j)(2) provides several exceptions to the application of § 101(j)(1), ***provided the notice and consent requirements of § 101(j)(4) are met***. Specifically, under § 101(j)(2)(A), § 101(j)(1) does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual, as defined, at the time the contract was issued. Under § 101(j)(2)(B), § 101(j)(1) does not apply to any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

[4307] P.L. 109-280, Sec. 863(a). Changing a split-dollar agreement without changing the underlying policy will not constitute a material modification under Code § 101(j), although it might very well affect other tax treatment. Notice 2008-42, discussed in part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns. 4191-4193.

[4308] Notice 2009-48, A-14 provides:

> The following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued. Thus, for example, a death benefit increase does not cause a contract to be treated as a new contract if the increase is necessary to keep the contract in compliance with § 7702, or if the increase results from the application of policyholder dividends to purchase paid-up additions, or if the increase is the result of market performance or contract design with regard to a variable contract. Notice and consent are required if a contract is treated as a new contract by reason of a material increase in death benefit or other material change, unless a valid consent remains in effect with regard to the insured.

[4309] Notice 2009-48, A-15 provides:

> Section 863(d) of the PPA provides that § 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in § 1035 for a contract issued on or before that date. Section 863(d) also provides that, for purposes of determining when a contract is issued, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. A § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract.

[4310] A-1.

[4311] Including through a grantor trust that the business established, per A-1.

[4312] After A-3 and before Q-4.

If plans do change, the Notice allows consent to be given before the death benefit exceeds the amount shown in the consent. The Notice also provides for a change in the employer.

The Notice further provides:

Q-1. Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

A-1. No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in § 101(j)(3).

Q-2. Can a contract be an employer-owned life insurance contract if it is subject to a split dollar arrangement?

A-2. Yes. A contract that is subject to a split dollar arrangement is an employer-owned life insurance contract if the contract is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). See § 1.61-22(c)(1) (defining the owner of a contract subject to a split dollar arrangement to be the person named as the policy owner of the contract). Under § 101(j)(2)(B), however, the general rule of § 101(j)(1) does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary.

Q-3. Is a contract an employer-owned life insurance contract if it is owned by a partnership or sole proprietorship that is engaged in a trade or business; the partnership or sole proprietorship is directly or indirectly a beneficiary under the contract; and, the contract covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued?

A-3. Yes. If a life insurance contract is otherwise described in § 101(j)(3), ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.

Q-4. Under § 101(j)(2)(A) and (j)(4), when is a contract treated as "issued" for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?

A-4. Generally, the issue date of a contract is the date on the policy assigned by the insurance company, which is on or after the date the application was signed. Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as "issued" on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in death benefit or other material change in the contract. See A-14, this Notice.

Q-5. For purposes of § 101(j), is the term "employee" limited to common law employees?

A-5. No. Section 101(j)(5)(A) provides that the term "employee" includes an officer, director, and highly compensated employee (within the meaning of § 414(q)). A director is an independent contractor in his or her capacity as a director.

Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly compensated employee (within the meaning of § 414(q)) if the individual was a highly compensated employee when he separated from service, or was a highly compensated employee at any time after attaining age 55. In addition, the term "employee" for purposes of § 414(q) includes an individual who is a self-employed individual who is treated as an employee pursuant to § 401(c)(1).

Although policies used to fund redemptions are subject to the notice and consent rules if the insured is either an employee or holds at least 5% ownership, an exception applies if and to the extent that the company uses the policy to redeem the insured's stock shortly after death:

A-6. In order to know whether an amount received as a death benefit under an employer-owned life insurance contract is eligible for exclusion from gross income under § 101(a), or is ineligible for exclusion under the general rule of § 101(j)(1), it is necessary to determine the availability of the exception for amounts used to purchase an equity (or capital or profits) interest in the applicable policyholder. Accordingly, an amount must be so paid or used by the due date, including extensions, of the tax return for the taxable year of the applicable policyholder in which the applicable policyholder is treated as receiving a death benefit under the contract.

I insist on notice and consent - even for redemption arrangements - because the purchase might not be completed within that deadline, the parties might later all agree that the money would be better used in the business, or the death benefit might exceed the purchase price.

II.Q.4.g.ii. Consent Integrated into Operating Agreement

As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below. See fn. 4300 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.g.ii is the sample:

The Company or Members may from time to time obtain life insurance policies on the lives of the Members. In the event those policies fall within the definition of "employer-owned life insurance policies" as defined in Code section 101(j), it is intended that the policies qualify for an exclusion from those rules (and thus the proceeds will be income tax-free) and that this Operating Agreement comply with the notice and consent requirements necessary to obtain that exclusion. Therefore, each Member is hereby given written notice that the Company or Members intend to insure his or her life by purchasing life insurance policy(ies) in the maximum face amount of $___________, and that the Company or Members will be the owner and beneficiary of that policy and of any proceeds payable on such Member's death. Each Member (by signing this Operating Agreement) hereby gives advance written consent to being insured under such policy(ies) and to the continuation of the policy(ies) after such Member ceases to have an Interest in the Company or otherwise terminates employment (as defined in Code section 101(j)(4)(B)) with the Company (and no inference is intended that a Member is an "employee" for any purposes other than the possible application of Code section 101(j)). The Members also agree to enter into a specific notice and consent containing these terms with regard to each policy obtained before the issuance of that policy.

II.Q.4.g.iii. Consent for Owner Who Is Not an Employee

As mentioned in part II.Q.4.g.i, a person owning at least 5% of a company is treated as an employee for purposes of this rule, even if that person not an employee. The rest of this part II.Q.4.g.iii is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _____ Owner

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.g.iv. Consent for an Employee

The rest of this part II.Q.4.g.iv is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _______ Employee

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.h. Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[4313] If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.[4314]

Regarding buy-sell agreements:[4315]

> **(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

[4313] Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.
[4314] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).
[4315] Reg. § 20.2031-2(h).

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[4316] If a buy-sell agreement is held to have testamentary intent rather than a legitimate business purpose, a bargain sale may constitute a gift.[4317]

For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. These rules extend to all sorts of arrangements:[4318]

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).[4319]

However, Code § 2703(b) provides that the above rules shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.[4320]

[4316] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11th Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, in *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the Huber opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

[4317] See quote from *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, in the text preceding fn 3616 in part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

[4318] Reg. § 25.2703-1(a)(3).

[4319] *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

[4320] *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

> We believe that [the transfer restrictions] were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term bona fide business arrangement in section 2703(b)(1) is not self-apparent. As discussed supra, in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, we interpreted the term bona fide

business arrangement to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of [the transfer restrictions]. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

The court had cited this portion of the legislative history (an informal report of the Senate Committee on Finance):

> [Buy-sell agreements] are common business planning arrangements … that … generally are entered into for legitimate business reasons…. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance….

The Eighth Circuit affirmed, 601 F.3d 763 (2010):

> Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no business, active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that maintenance of family ownership and control of [a] business may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39–40 (1977). We have not so held, however, in the absence of a business. [footnote described below]
>
> That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to carrying on a business); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.).

In footnote 3 discussing the *St. Louis County Ban*k case, 674 F.2d 1207 (8th Cir. 1982), the court pointed out:

> In *St. Louis County Bank*, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. *St. Louis Bank*, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. *Id*. At 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. *Id*. With this new activity, the formula resulted in a dramatically lower value. *Id*. We stated, We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose. *Id*. at 1210.

Judge Beam offered a strong dissent:

> Here, the Tax Court made the express factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership's legitimate, non-tax goals. [footnote omitted]

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.[4321]

The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.

…Under § 2703(b)(3)'s comparable terms test, the Holman partnership restrictions' terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length. [footnote omitted] Holman, 130 T.C. at 198–99. The Tax Court explained that this would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3). Id. at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

The U.S. District Court for the Southern District of Indiana, following *Holman*, held that holding undeveloped land did not constitute a business that could qualify for the Code § 2703 safe harbor. *Fisher v. U.S.*, 106 A.F.T.R.2d 2010-6144. The court later ruled that the taxpayer could not introduce into evidence the discounts that the IRS had used on audit, ruling that the IRS' audit determination was irrelevant to determining the actual value. 106 A.F.T.R.2d 2010-6144.

For an in-depth discussion of the facts of some of these cases, see Aghdami, Mancini, & Zaritsky, *Structuring Buy-Sell Agreements*, ¶ 6.02[4] Restriction on Lifetime Transfer.

[4321] Judge Beam's dissent in *Holman v. Commissioner*, 601 F.3d 763 (2010), argued that "decedent" in Code § 2703(b)(2) means it does not apply to gifts:

Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s device test. Under this test, the Holman partnership restrictions must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase members of the decedent's family found in § 2703(b)(2) and substitutes in its place the phrase natural objects of the transferor's bounty, apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term decedent unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term decedent, not the broader term transferor, is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term decedent is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes. It is clear that the phrase members of the decedent's family unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term decedent is itself unambiguous. *Black's Law Dictionary* 465 (9th ed. 2009) plainly defines decedent as [a] dead person. Moreover, the phrase

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[4322]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals

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> members of decedent's family is not ambiguous when read in the greater context of Chapter 14. While Congress used the term decedent in § 2703(b)(2), it used the broader term transferor in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term decedent consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase members of the decedent's family with the Commissioner's phrase natural objects of the transferor's bounty. See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not decedents and § 2703(b)(2)'s device test is satisfied.

Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wis. 3/26/2019), held that Code § 2703(b)(2) does not apply to gifts (highlighting added):

> Under the second requirement, the Restriction cannot be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth." § 2703(b)(2). Citing Treasury Regulation § 25.2703–1, the Government contends that this second requirement applies not only to transfers at death but also to inter vivos transfers. See 26 C.F.R. § 25.2703–1(b)(1)(ii) ("The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth."). The Government argues that the term "decedent" in § 2703(b)(2) is ambiguous in light of the statute's place within Subtitle B, Chapter 14 of the Internal Revenue Code, which includes other valuation rules targeting transfer avoidance schemes, and thus the court should defer to the agency's interpretation of the statute.…
>
> Although Chapter 14 is intended to generally address transfer tax avoidance schemes, it is clear from the statute itself that the phrase "members of the decedent's family" unambiguously limits its application to transfers at death. See Black's Law Dictionary (10th ed. 2014) (defining "decedent" as a "dead person, especially one who has died recently"); see also *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 (W.D. Pa. June 30, 2004) (noting that "one of Congress's primary concerns [in enacting § 2703(b)(2)] was the free passage of wealth to family members through a device that is testamentary in nature"). Although Congress has attempted to amend § 2703(b)(2) to conform with the agency regulations, no such legislation has been enacted. See *Smith*, 2004 WL 1879212, at *6 n.3 (citing HR Conf. Rep. 1555, 102d Cong., 1st Sess. (1991); The Revenue Bill of 1992, HR Conf. Rep. 11, 102d Cong., 2d Sess. (1992)); see also *Holman*, 601 F.3d at 781 (Bean, J., dissenting) ("I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase `members of the decedent's family' with the Commissioner's phrase `natural objects of the transferor's bounty.'").
>
> In short, I find that Congress has spoken unambiguously to the precise question at issue: § 2703(b)(2) applies specifically to transfers at death. Because Plaintiffs gifted their shares to their family members as living persons, they are, by definition, not decedents. Therefore, § 2703(b)(2) is satisfied. But even were I to conclude that § 2703(b)(2) does apply to inter vivos transfers, this would not change the result. For as noted above, the family transfer restrictions serve the bona fide purpose of maintaining family ownership and control of the business, and were not intended as a tax avoidance device.

[4322] Reg. § 25.2703-1(b)(3).

must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[4323]

(i) <u>In general</u>. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) <u>Evidence of general business practice</u>. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[4324]

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,[4325] in that they cloud the business' future operations.[4326]

[4323] Reg. § 25.2703-1(b)(4).
[4324] T.C. Memo. 2006-76.
[4325] Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.
[4326] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value; *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005), *rev'g* T.C. Memo. 2004-116.

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.[4327] If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.[4328] Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.[4329] However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.[4330] Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.[4331] Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.[4332]

Letter Ruling 202014006, approving certain actions and amendments as not ruining grandfathering. Facts included:

> As a result of the transfers of shares of Company stock since the Agreement date, Date 1, Company is now owned by Daughters, C, D, and E, six living grandchildren F, G, H, J, K, and L, as well as six GST Trusts created by C on Date 9.
>
> The Board of Directors of Company proposes to cancel all shares of Company common stock held in treasury and to recapitalize Company so that newly issued voting stock in Company can thereafter be primarily held by shareholders who are active in the management of Company. To accomplish this, Company will amend its Articles to increase the number of common shares and to immediately convert each outstanding common share into one share of Class A voting common stock and x shares of Class B

[4327] Reg. § 25.2703-1(c)(1).
[4328] Reg. § 25.2703-1(c)(1).
[4329] Reg. § 25.2703-1(c)(1).
[4330] Reg. § 25.2703-1(c)(2).
[4331] Letter Ruling 201313001.
[4332] Letter Ruling 201536009, reasoning:

> In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.
>
> Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.
>
> Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

nonvoting common stock. After adoption of the foregoing amended capital structure, the Articles and the Agreement will be amended to reflect the common stock split and the addition of the Class B nonvoting common stock (Plan of Recapitalization).

In addition and as indicated above, after approval of the changes to the corporate structure, C, D and E propose to transfer shares of her Class B nonvoting common stock to the GST Trusts created by her on Date 9 (with respect to C) and Date 10 (with respect to each of D and E).

Letter Ruling 202014006 held:

Ruling #1

The individuals and trusts who were parties to the Agreement as of Date 1 are A, B, C, D, E, the Daughters' Trust, and the six Grandchildren's' Trusts (excluding L's Trust). Under § 2651, A and B, as parents and grandparents of the other parties to the Agreement, are assigned to the eldest generation, which will be referred to as the First Generation. C, D and E, as children of A and B, are assigned to the generation immediately below the First Generation and will be referred to as the Second Generation. The Daughters' Trusts are also assigned to the Second Generation because C, D and E are the only current beneficiaries of the Daughters' Trusts. The six Grandchildren's' Trusts (excluding L's Trust) are assigned to the Third Generation, as each trust benefits only a grandchild of A and B.

There are nine transactions or events after October 8, 1990, in which new parties were treated as having been added to the Agreement. The nine events occurred as follows: (i) on Date 3 with the addition of A's estate upon the death of A; (ii) through (vii) through the addition of F, G, H, J, K, and L, on the date each respective Grandchild's Trust distributed shares of Company stock subject to the Agreement to each such Grandchild, outright and free of trust; (viii) on Date 5 with the addition of B's estate upon the death of B, and (ix) on Date 9 when C transferred shares of her Company stock to the GST Trusts C created, each benefiting a niece or nephew of C.

On Date 2, a date after Date 1 but prior to October 8, 1990, A and B created and funded with shares of Company stock a seventh Grandchild's Trust for L (L's Trust), a newly-born descendant. Since L's Trust was not in existence on Date 1, L's Trust was not a party to the Agreement. However, L's Trust was treated as having been added to the Agreement when it received the shares of Company stock from A and B. Pursuant to Paragraph 1 of the Agreement, the gifted shares were subject to the terms of the Agreement and to the obligations of the transferors thereunder and L's Trust was prohibited from transferring such shares except in accordance with the Agreement. Pursuant to Paragraph 8 of the Agreement, the Endorsement appeared on the certificates issued to L's Trust. Accordingly, the addition is mandatory under the terms of the right or restriction within the meaning of § 25.2703-1(c)(1). Further, under § 2651(f)(2), L's Trust is assigned to the same generation as the sole beneficiary, L, a grandchild of A and B. Therefore, L's Trust is assigned to the Third Generation of family members already parties to the Agreement. Accordingly, L's Trust is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction, within the meaning of § 25.2703-1(c).

On Date 3, A died, survived by his spouse, B, and his Daughters, C, D, and E, and his grandchildren. Pursuant to A's will, B, C, D, and E were the beneficiaries of A's estate. Accordingly, pursuant to § 2651(f)(1) and (2), A 's estate was assigned to the Second Generation of shareholders already parties to the Agreement. Accordingly, the addition of A's estate to the Agreement was the addition of a family member of no lower a generational assignment than the family members already party to the Agreement on Date 1.

On Date 4, and subsequently, the trustee of the Grandchildren's Trusts benefiting F, G, H, J, K, and L distributed shares of Company stock subject to the Agreement to the grandchild for whom a Grandchild's Trust was held, outright and free of trust. The foregoing transfers for J, K and L included shares of Company stock received from Grandchild's Trust for I upon I's death. F , G, H, J, K, and L were treated as having been added to the Agreement when shares of Company stock were distributed to them, outright and free of trust. Pursuant to § 2651(f)(2), each Grandchild's Trust was assigned to the same generational assignment as its sole beneficiary, a grandchild of A and B. Therefore, the addition of the beneficiary of each Grandchild's Trust to the Agreement was the addition of a family member of no lower a generational assignment than the individuals already party to the Agreement as of Date 1.

On Date 5, B died, survived by her Daughters, C, D, and E, and her grandchildren. B's estate is treated as a new party to the Agreement. Pursuant to B's will, C, D , and E were the beneficiaries of B's estate. C, D, and E executed partial disclaimers which resulted in F, G, H, I, J, K , and L acquiring beneficial interests in B's estate. Pursuant to § 2651(f)(1) and (2), B 's estate is treated as being assigned to the Third Generation of shareholders. Therefore, the addition of B's estate to the Agreement was the addition of a family member of no lower than the generational assignment of the individuals already party to the Agreement as of Date 1.

On Date 9, C created and funded six GST Trusts with shares of Company stock for the initial benefit of each of her six living nieces and nephews. A niece or nephew of C, each of whom is also a grandchild of A and B, is the sole beneficiary of each GST Trust for and during the lifetime of each such beneficiary. There are no other permissible distributees from any such GST Trust during such time. Therefore, pursuant to § 2651(f)(1), each GST Trust is treated as being assigned to the Third Generation. Accordingly, a transfer of shares of Company stock subjecting the GST Trust to the Agreement is treated as a transfer to a family member of no lower than the generational assignment of the parties already subject to the Agreement on Date 1. The Agreement was adopted before October 8, 1990 and, consequently is exempt from the application of § 2703, provided the Agreement is not substantially modified as set forth in § 25.2703-1(c). No family member which is treated as having been added to the Agreement after October 8, 1990 is assigned to a lower generational assignment than the parties already subject to the Agreement on Date 1. Accordingly, based upon the information submitted and representations made, we conclude that none of the transfers of shares of Company stock subject to the Agreement after October 8, 1990, constitute substantial modifications within the meaning of § 25.2703-1(c). Consequently, the Agreement continues to be grandfathered for purposes of chapter 14.

Ruling #2

On Date 7, a date after October 8, 1990, Company amended the Articles to change its name to the current name. On Date 8, Company amended and restated the Articles. Also on Date 8, Company amended and restated the Bylaws that included administrative changes such as name change, indemnification, and number of members constituting the Board of Directors.

Based upon the facts submitted and representations made, we conclude that none of the amendments to the Articles on Date 7, the amendments and restatement of the Articles on Date 8, and the amendment and restatement of the Bylaws on Date 8 constitute substantial modifications of any right or restriction in the Articles, the Bylaws, or the Agreement within the meaning of § 25.2703-1(c). Consequently, we conclude that the Articles, the Bylaws, and the Agreement continue to be grandfathered for purposes of chapter 14.

Ruling #3

The proposed Plan of Recapitalization includes a stock split of one share of Company common stock into one share of Class A voting common stock and x shares of Class B nonvoting common stock. The Articles and Agreement will be amended to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure. The issuance of the Class B nonvoting common stock does not change the terms and conditions to which the shareholders are already subject. In addition, the beneficial interest in the Company will not be affected by the stock split because each shareholder of common stock will receive x shares of Class B nonvoting common stock for every share of common stock held prior to the recapitalization. Accordingly, we conclude that the recapitalization does not affect the quality, value, or timing of any rights of the parties to the Agreement.

Based upon the facts submitted and representations made, we conclude that the proposed Plan of Recapitalization, the proposed amendments to the Articles and Agreement to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure, and the issuance of Class B nonvoting common stock, will not constitute substantial modifications of the Agreement or the Articles within the meaning of § 25.2703-1(c). Further, we conclude that the proposed Plan of Recapitalization and the proposed amendments, described above, will not cause § 2703 to apply to transfers of shares of Company stock subject to the Agreement, as amended.

Ruling #4

C, D and E propose to transfer shares of Class B nonvoting stock in the Company to the GST Trusts created by each. Each GST Trust is assigned to the Third Generation of family members subject to the Agreement. We concluded under Ruling 1 that the prior transfers by C of shares of Company stock to C's GST Trusts do not cause a substantial modification of the Agreement. We likewise conclude that the proposed transfers of shares of Company stock by C to her GST Trusts do not cause a substantial modification to the Agreement. Similarly, the proposed transfers by D and E of shares of Company stock to D's and E's GST Trusts, respectively, do not cause a substantial modification of the Agreement.

> Accordingly, based upon the facts submitted and representations made, we conclude the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not constitute substantial modifications of the Agreement within the meaning of § 25.2703-1(c). Further, we conclude that the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not cause § 2703 to apply to the transfer of shares of Company stock subject to the Agreement, as amended.

Letter Rulings 202014007, 202014008, 202014009, and 202014010 are reported to be companion rulings to Letter Ruling 202014006. Letter Rulings 202015004-202015013 also appear to be companion rulings.

BNA Daily Tax Report (4/24/2020) described ten letter rulings:[4333]

> In 10 similar ruling letters, the IRS concluded that certain events occurring after October 8, 1990 (the date defining whether tax code Section 2703 applies), subject to an agreement that "Company" shareholders (individuals and trusts in a family lineage) entered into before that date, don't constitute substantial modifications of the Agreement or other applicable documents within the meaning of Treasury Regulations Section 25.2703-1(c) such that would cause application of these sections. The events are: (rulings 1,2) transfers of Company shares and additions of new parties to the Agreement - including the estates of first-generation individuals (a husband and wife) upon their deaths, and new generation-skipping transfer (GST) tax-exempt trusts for additional or newly born family members none of whom are assigned to a lower generation than those already subject to the Agreement - as well as amendment and restatement of Company's Articles of Incorporation (including name change); consequently grandfathering continues on all the applicable documents for purposes of Chapter 14 (Special Valuation Rules) of the tax code; (ruling 3) proposed amendments to the Articles and Agreement to reflect Company's plan of recapitalization, including a stock split into voting and nonvoting common shares, deemed as not affecting the quality, value, or timing of any rights of the parties to the Agreement; and (ruling 4) proposed transfers of Company shares by second-generation trust beneficiaries to GST trusts for third-generation beneficiaries.

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

II.Q.4.i. Life Insurance LLC

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[4334] and keep the life insurance policies in a safer environment? One solution is to place the policies in a limited liability company (LLC) taxed as a

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[4333] Letter Rulings 202017001, 202017002, 202017003, 202017004, 202017005, 202017006, 202017011, 202017012, 202017013, 202017014.

[4334] See text accompanying fns. 4076-4078 regarding certain transfers involving partnerships.

partnership. The owners of the business entity also would be the members (owners) of the LLC. A trust company could serve as manager, taking charge of the policies and ensuring that the proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts. The buy-sell agreement was funded by term life insurance policies.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies on Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

II.Q.4.i.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity

Code § 2042(2) provides that an insured's gross estate includes the value of all property "to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[4335]

Code § 2035(a) provides:

> If—
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 , 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Reg. 20.2042-1(c)(1) begins with:

> Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

Then it continues by pointing out inclusion when incidents of ownership are transferred too soon to death, which is now covered by Code § 2035.

[4335] It continues:

> For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

Reg. 20.2042-1(c)(2) provides:[4336]

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides, "A decedent is considered to have an 'incident of ownership' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent…has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust." Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, results in estate tax inclusion under Code § 2042? *Skifter*, 468 F.2d 699 (2nd Cir. 1972) held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute. GCM 39317 followed this case. However, *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975) held that there was no transfer requirement. Rev. Rul. 84-179 reasoned:

> The legislative history of section 2042 indicates that Congress intended section 2042 to parallel the statutory scheme governing those powers that would cause other types of

[4336] Reg. 20.2042-1(c)(2) elaborates:

> The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

property to be included in a decedent's gross estate under other Code sections, particularly sections 2036 and 2038. S. Rep. No. 1622, 83rd Cong., 2d Sess. 124 (1954). See *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).

Sections 2036(a)(2) and 2038(a)(1) concern lifetime transfers made by the decedent. Under these sections, it is the decedent's power to affect the beneficial interests in, or enjoyment of, the transferred property that required inclusion of the property in the gross estate. Section 2036 is directed at those powers retained by the decedent in connection with the transfer. See, for example, *United States v. O'Malley*, 383 U.S. 627 (1966), 1966-2 C.B. 526. Section 2038(a)(1) is directed at situations where the transferor-decedent sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to the transferor-decedent, such as by an incomplete transfer. See *Estate of Reed v. United States*, Civil No. 74-543 (M.D. Fla., May 7, 1975); *Estate of Skifter v. Commissioner*, above cited, at 703-05.

In accordance with the legislative history of section 2042(2), a decedent will not be deemed to have incidents of ownership over an insurance policy on decedent's life where decedent's powers are held in a fiduciary capacity, and are not exercisable for decedent's personal benefit, where the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent. This position is consistent with decisions by several courts of appeal. See *Estate of Skifter*; *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980). But see *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), which are to the contrary. Section 20.2042-1(c)(4) will be read in accordance with the position adopted herein.

The decedent will be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred to property to the trust. *Estate of Fruehauf*; *Estate of Skifter*, above cited at 703. Thus, if the decedent reacquires powers over insurance policies in an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee.

In the present situation, D completely relinquished all interest in the insurance policy on D's life. The powers over the policy devolved on D as a fiduciary, through an independent transaction, and were not exercisable for D's own benefit. Also, D did not transfer property to the trust. Thus, D did not possess incidents of ownership over the policy for purposes of section 2042(2) of the Code.

Rev. Rul. 84-179 held:

An insured decedent who transferred all incidents of ownership in a policy to another person, who in an unrelated transaction transferred powers over the policy in trust to the decedent, will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2) of the Code, provided that the decedent did not furnish

> consideration for maintaining the policy and could not exercise the powers for personal benefit. The result is the same where the decedent, as trustee, purchased the policy with trust assets, did not contribute assets to the trust or maintain the policy with personal assets, and could not exercise the powers for personal benefit.

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.
>
> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.
>
> Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).
>
> We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 200314009 found no incidents of ownership where a grantor had the power to name as a successor trustee anyone except himself or any party related or subordinate to the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

> A decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and Rev. Rul. 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent).[4337]

In Letter Rulings 201919002-201919003, the settlor established an irrevocable trust for the benefit of Child 1 and Child 1's descendants, with the trustee being Child 1. When the trustee planned to buy life insurance, the trustee petitioned to have the trust modified so that Child 2 (presumably Child 1/s sibling) would serve as special trustee over insurance, holding all incidents of ownership, and Child 1 would have no power of appointment over the life insurance policy. However, Child 1 had the power to change trustees, so long Child 1 did not appoint a person related to or subordinate to Child 1, within the meaning of Code § 672(c), as successor insurance trustee. Citing Rev. Rul. 84-179 but not Rev. Rul. 95-58, the ruling held:

> In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

A decedent's right to veto a change in the transfer of a policy, where the decedent could gain no economic benefits from the veto power, did not constitute incidents of ownership.[4338]

[4337] "Related or subordinate" looked to Code § 672(c) – see fn. 2435 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

[4338] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

The mere right to the dividends, by itself, is not an incident of ownership that would cause the value of the insurance proceeds to be included in Decedent's gross estate under Code § 2042(2).[4339] This conclusion was based on the view that dividends represent a return of premiums[4340] and did not address whether dividends in excess of premiums would be treated differently.

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[4341] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

Letter Rulings 9625022 and 9625023 ruled that life insurance proceeds would not be included in the estate of a member in a limited liability company (that was taxed as a partnership) who could

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[4339] CCA 201328030.

[4340] CCA 201328030 cited *Estate of Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (the right to dividends, which may be applied against a current premium, is nothing more than a reduction in the amount of premiums paid rather than a right to the income of the policy) and *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975) (since dividends are merely a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership).

[4341] *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq*. in result, 1959-1 C.B. 4, *aff'd* on another issue 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

not participate in decisions regarding a policy insuring the member's life held. Letter Rulings 9625013-9625019 had the same result and also involved using the proceeds to fund the purchase of a deceased owner's share of a related corporation and also of the limited liability company, which held real estate that it rented to the corporation.

Letter Rulings 9843024 and 200111038 held that the insured limited partner does not possess incidents of ownership in the policy if the partnership agreement precludes the limited partners from exercising any control over the partnership's management and investment activities.

Letter Ruling 200017051 ruled that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement expressly states that an insured partner "had no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies."[4342]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.[4343] Formation of

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[4342] It did not think to cite cases involving trust-owned insurance on a beneficiary's life, where no incidents of ownership were attributed to the beneficiary. Letter Rulings 9602010 and 9748020. Rev. Rul. 84-179 might also be helpful.
[4343] Code § 101(a)(2).

the LLC should not implicate these rules, because formation is a nontaxable transfer.[4344] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[4345] In our case, the Members also participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.[4346]

II.Q.4.i.iv. Significance of Letter Ruling 200747002

The ruling has other implications. Using a corporate trustee to hold the policies as manager of the LLC provides security that the proceeds will be used as intended. As mentioned, one of the disadvantages of a cross-purchase is that a shareholder's creditors might be able to prevent application of the proceeds. Depending on applicable state law, the insurance being in an LLC might make a charging order the exclusive remedy. A charging order allows creditors to receive any distributions that belong to the debtor but does not allow the creditor to force the LLC to make distributions. The manager's duty to the other members would prevent the proceeds from being distributed without the consent of the deceased shareholder's beneficiaries.

The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. The additional restrictions should be placed in the operating agreement only if seeking a Letter Ruling or advising a client who is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.

Letter Ruling 200747002 is not geared towards a policy with cash values. However, through a split-dollar arrangement, one might carve out the term portion for the LLC and make other arrangements with the cash value.[4347] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner. Based on more recent informal conversations with a representative of the government, my understanding is that, although the IRS has no plans to change its approach toward Code Sec. 678 when it issues Letter Rulings, it also has no plans to issue a formal pronouncement upon which taxpayers can generally rely.

The above issues are as far as was the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation.

[4344] Code §§ 101(a)(2)(A), 721(a).
[4345] Code § 721(a).
[4346] Code § 101(a)(2)(B).
[4347] See footnote 4041 for a summary of how split-dollar arrangements work.

The net cash flow from the rental operations would be used to pay the life insurance premiums through the insurance LLC. Thus, the income tax goal of holding real estate in partnerships was married with leveraging gifts to generation-skipping trusts.

Second, Trusts 2A and 2B were ideal for the tactic of selling stock to an irrevocable grantor trust.[4348] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

First, keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent are required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[4349]

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

[4348] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[4349] See fn. fn. 4300, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.

If the operating business is an S corporation, it would account for the premium payments as compensation or as a distribution. Compensation tends to be the more popular choice, in that it can be non-pro rata, but the parties' economic deal might make distributions more attractive, and any temporary timing differences of distributions should not cause problems with the S corporation single class of stock rules.[4350]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

When the operating company pays a term premium, the life insurance LLC would credit the relevant owner's capital account with a contribution and debit premium expense, with the premium expense separately allocated to the relevant owner.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[4351] That partnership and other partnerships (in which the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

II.Q.4.i.vii. Conclusion

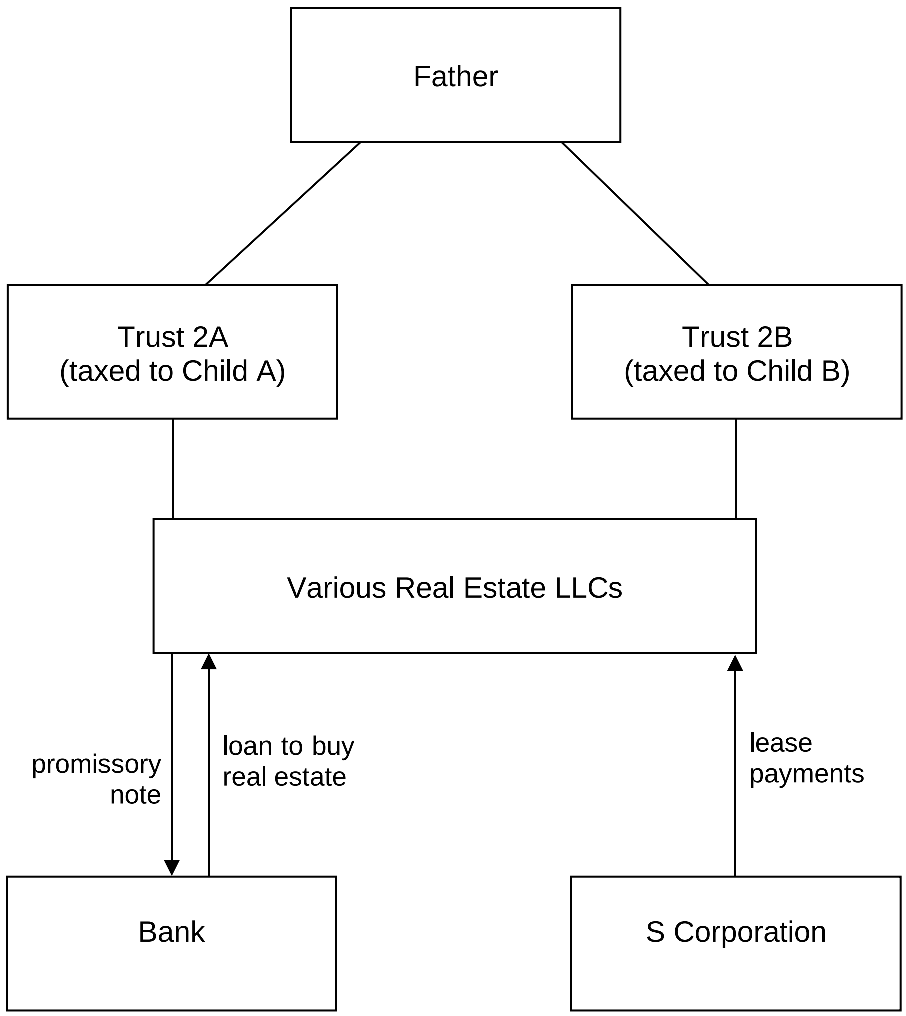
The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[4352] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[4353]

[4350] See part II.A.2.i.ii Temporary Timing Differences.
[4351] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.
[4352] For basis changes when a partner dies, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. For basis changes on the death of an owner other than the insured, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.
[4353] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

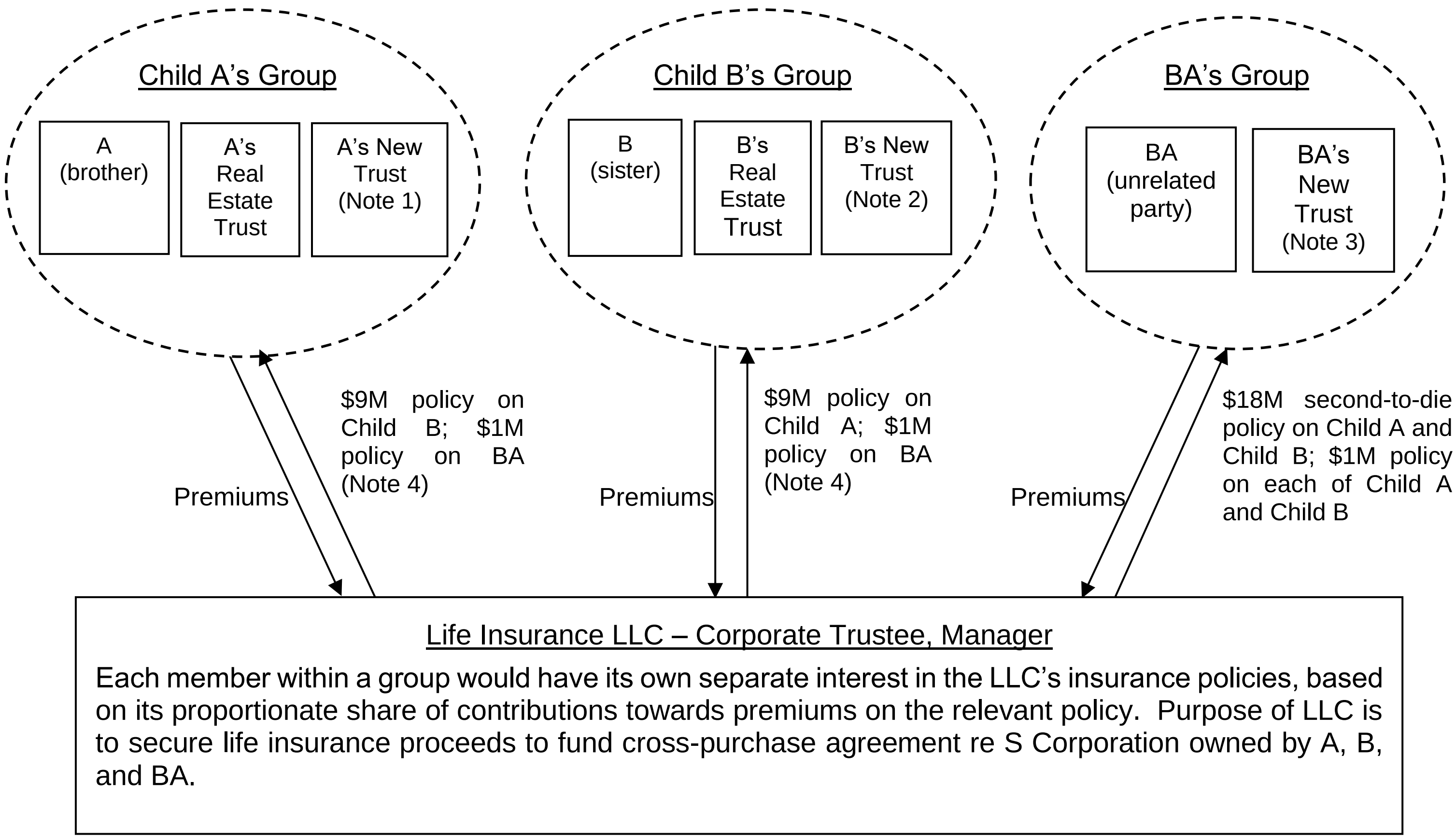
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

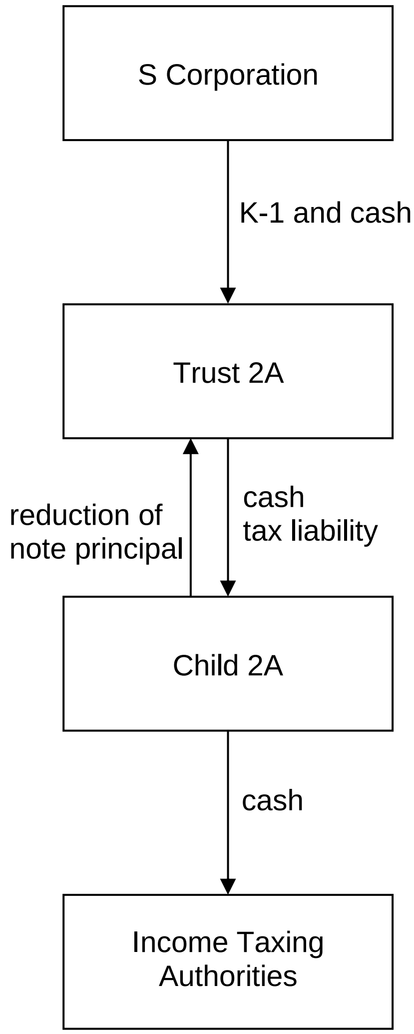
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S corporation Stock to Irrevocable Grantor Trust



II.Q.7.b.iii. S Corporation Receipt of Life Insurance Proceeds

In Letter Ruling 200409010, upon the death of the key person, the S corporation (presumably using the accrual method of accounting) would immediately redeem the stock held by the key person at the time of death by issuing a promissory note to the key person's estate. After the redemption, the remaining shareholders would elect to cut off the taxable year.[4614] By terminating the taxable year after the redemption but before submitting a claim on the life insurance policy, the remaining shareholders sought to have all of the insurance proceeds allocated to their stock for purposes of increasing their tax basis. The IRS ruled that the life insurance death benefit will be required to be recognized as of the date of death. Notwithstanding needing to go through the claims submission and evaluation process, death would establish the corporation's rights to the proceeds as a beneficiary of the insurance policy.

Thus, the basis increase due to the receipt of the life insurance death benefit would not be allocated solely to the surviving shareholders. By using a redemption, they would have received a smaller basis increase than if they had received the life insurance proceeds directly and bought the decedent's stock. In fact, if and to the extent that an accounting cut-off can<u>not</u> be made, a portion of the basis increase would be allocated to the decedent's stock and perhaps subsumed (and, as a practical matter, lost) in the basis step-up of that stock upon death. If the accounting cut-off places date of death events into the decedent's hands, then perhaps the decedent's portion of basis from nontaxable income would be allocated to the decedent's stock and subsumed (and, as a practical matter, lost) in the basis step-up of that stock upon death.

Although cash basis taxpayers should be able to avoid these issues, be careful to see how the accounting cut-off would apply, because it can be quite tricky.

To avoid these issues, I tend to prefer the planning in part II.Q.4.i Life Insurance LLC.

II.Q.7.b.iv. S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds

II.Q.7.b.iv.(a). S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations

Below is a variation of the theme of part II.P.3.b.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

In Rev. Rul. 2008-42,[4615] an S corporation purchased an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee was a highly compensated employee of the corporation. The corporation paid all of the premiums for the policy and was the beneficiary of the policy. At the end of the taxable year, the corporation had earnings and profits ("E&P"). The IRS reminded us that Code 101(j) imposes notice and reporting requirements regarding employer-owned life insurance to preserve the Code § 101 exclusion of life insurance proceeds from income taxation.[4616]

[4614] Code § 1377(a)(2); for more details, see part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.
[4615] See New Ruling Provides Guidance on AAA of S corporations, *Business Entities* (WG&L) (Jan./Feb. 2009).
[4616] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

The IRS ruled that premiums paid did not reduce the S corporation's AAA. It also ruled that the death benefit received does not increase the S corporation's AAA. What the IRS does not point out is the general ordering rules of Code § 1368, which are that distributions from an S corporation are treated as the following:[4617]

1. A tax-free distribution to the extent of the lesser of stock basis or AAA, then

2. A taxable dividend to the extent of E&P, then

3. Return of principal to the extent of remaining basis, and finally

4. Capital gain.

Suppose, for example, that the shareholders contributed $10,000 to the corporation at its inception, and no stock has been transferred since inception. It operated as a C corporation and earned $1,000,000 of E&P. Then it elects S status and has $250,000 of AAA. A key employee dies, and the corporation receives $1,500,000 of life insurance proceeds from a term policy and then distributes $700,000 to the shareholders. The consequences are:

- Immediately before the employee died, the shareholders had tax basis in their stock of $260,000, which is the sum of the initial $10,000 contribution and the $250,000 of AAA. Immediately after the death, this tax basis is increased to $1,760,000 due to the receipt of death benefits.

- Of the $700,000 the shareholders receive, $250,000 is a tax-free return of AAA that they could have pulled out tax-free before the employee died; their stocks' tax basis is reduced to $1,510,000 by reason of the $250,000 tax-free distribution. The remaining $450,000 is a taxable dividend out of the $1,000,000 E&P, even though it can be traced to the tax-free life insurance proceeds and even though the shareholders have ample basis to receive distributions if the corporation had never been a C corporation. E&P is reduced to $550,000, since $450,000 out of the $1,000,000 E&P has been distributed.

Turning tax-free life insurance proceeds into taxable dividends – not a good deal!

Suppose instead that the shareholders had owned the policy, had been the beneficiaries, and had received distributions from the corporation to pay premiums:

- Each year, AAA would have been reduced to the extent of the distributions that were used to pay premiums.

- The shareholders receive the life insurance proceeds tax-free, assuming they complied with Code § 101(j) as in the Revenue Ruling.

- When the shareholders invest into the company the $800,000 that, under the above example was retained in the corporation, their stock basis increases by that $800,000 to $1,060,000 from the pre-death $260,000 used in the example.

[4617] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

- Thus, the shareholders have lower basis than in the first example, which is the price they pay for not having dividend income.

- If future distributions exceed AAA, they could have dividend income up to the full $1,000,000 of E&P.

Thus, this alternative defers dividend taxation but does not avoid it if future distributions significantly exceed AAA. However, if future distributions in excess of AAA are in the form of redemptions that are taxed as such, then this alternative might very well avoid dividend taxation.

A more tax-efficient way to structure this alternative would be for the shareholders to contribute their $800,000 investment of the life insurance proceeds to a new limited liability company taxed as a partnership. Then either:

- The new LLC loans the proceeds to the S corporation as needed, documenting the loan with interest at the applicable federal rate, or

- The S corporation then contributes all of its business assets to the LLC. Later, when the LLC does not need part or all of the $800,000 anymore, it can distribute that excess money to the shareholders as a tax-free return of their capital contribution. This might or might not be a practical alternative, depending on the non-tax issues caused by transferring the S corporation's assets, as well as the annual expense of filing two business income tax returns instead of one. This is more cumbersome than the loan alternative, but it might have the positive effect of shifting a significant portion of the business operations to a partnership income tax model, which is more tax-efficient when changing the composition of the business' equity ownership, as discussed at the beginning of part II.M Buying into a Business, as well at part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules, of these materials.

Finally, to protect the life insurance from various business exigencies inherent in the shareholders owning life insurance under the alternative, the shareholders should consider forming a limited liability company to hold the life insurance.

These issues could be avoided if the corporation had an S election in place from inception or to the extent it had distributed all of its E&P in the past. Owners of S corporations with E&P might consider cleansing the corporation's E&P while dividend rates are low. Code § 1368(e)(3) allows taxpayers to elect to reverse the normal distribution rules and have distributions come first from E&P and then from AAA to implement this strategy.[4618]

Finally, owners of limited liability companies or other entities taxed as partnerships would not need to even consider this issue.

II.Q.7.b.iv.(b). S Corporation Redemptions Using Life Insurance Proceeds

When an S corporation redeems stock under Code § 302(a) or 303(a):

[4618] See part II.P.3.b, for issues relating to S corporations that have E&P.

- AAA is reduced by an amount equal to the AAA multiplied by the number of shares redeemed and divided by the number of shares of stock in the corporation immediately before the redemption.[4619]

- E&P is reduced by a ratable share of post-2/28/1913 E&P.[4620]

- These reductions in AAA and E&P are independent of each other.[4621]

If an S corporation is a former C corporation with significant E&P, then a disadvantage of a redemption relative to a cross-purchase is that AAA is reduced in a redemption, whereas in a cross-purchase AAA is not affected. (It could be an advantage if the goal is to cleanse the corporation of E&P to avoid worrying about the passive investment income rules, but those rules are easy to work around by investing in oil and gas partnerships; see part II.P.3.b.iii Excess Passive Investment Income.)

III.B.2.j. Tax Allocations upon Change of Interest in a Business

Both S corporations and partnerships are flow-through entities. The grantor trust rules treat a grantor as owner of the trust for federal income tax purposes. As such, the income generated by the grantor's business, through the trust, is imputed back to the grantor. This income, naturally, generates tax liability.

In the case of either a GRAT or sale to an irrevocable grantor trust, generally the grantor is taxed on all of the trust's income, and payments back to the grantor have no income tax consequences.[6553] A GRAT can be disastrous to the grantor if the company is very successful and the grantor has to pay income tax in excess of the grantor's payments (an "exploding GRAT"), so GRATs should allow the grantor to be reimbursed for income taxes on part or all of the GRAT's income. This generally is not necessary for an irrevocable grantor trust, which is usually drafted so that the grantor trust taxation can be turned off. The trust agreement may authorize an independent trustee to reimburse the grantor's income tax so long as the decision to reimburse is made in the trustee's absolute discretion and cannot be legally compelled by the grantor.[6554]

This issue is only magnified by the sale of the business. Now, instead of just the imputed income generated by the business, the grantor must pay taxes on any gain from the sale. Ideally, the grantor would like to "turn off" the grantor trust features, essentially making the trust the owner for income tax purposes.[6555] Turning off the grantor trust features generally would be deemed, for

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[4619] Code § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1)(i).

[4620] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[4621] Reg. § 1.1368-2(d)(1)(iii).

[6553] For the lack of income tax on payments using appreciated property, see Rev. Rul. 85-13.

[6554] Rev. Rul. 2004-64, Situation 2; see fns. 6682-6700, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .

[6555] Be sure not to get too cute in deciding which trusts are grantor trusts and when to turn powers on or off. See Notice 2007-73.

income tax purposes, as a transfer from the grantor to the trust at that time.[6556] If a person is treated as the owner of an entire trust (corpus as well as ordinary income), that person takes into account in computing that person's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which that person would have been entitled had the trust not been in existence during the period that person is treated as owner.[6557] See also part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

The next part discusses the income tax effect of turning off grantor trust status, followed by tax allocations upon a change of interest in S corporations and partnerships. See also part III.A.3.c Deadlines for Trust Qualifying as S Corporation Shareholder.

III.B.2.j.i. Changing Grantor Trust Status

An article from a prolific tax planner discusses the effect of changing grantor trust status during the grantor's life:[6558]

- Pass through entities
- Payments of estimated taxes
- Suspended losses
- Basis
- Carryovers (including excess deductions on termination under Code § 642(h).[6559]

[6556] See fns. III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation, especially timing issues described in fns. 6287-6289. See also part III.B.1.c.i Gifts with Consideration – Bargain Sales.

[6557] See part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation. Although various rulings discuss how this affects the accounting period the trust generally uses to report income, rulings discussing the exact timing are scarce. Rev Rul. 85-13 held:

(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code.

(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets. Accordingly, when A sold the shares of Corporation Z stock on January 20, 1984, A recognized gain of $30x (amount realized of $50x less adjusted basis of $20x). Further, this holding would apply even if the trust held other assets in addition to A's promissory note if A, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because A would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction. See section 1.671-3(a)(2) of the regulations.

[6558] Peebles, Mysteries of the Blinking Trust, *Trusts and Estates*, pp. 16-20 of Sept. 2008 issue, which is saved as Thompson Coburn LLP doc. no. 5654628. For changing grantor status by reason of the deemed owner's death, see fn 6325 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[6559] See part II.J.3.i Planning for Excess Losses.

Note that a change in grantor trust status would not be eligible[6560] for an S corporation accounting cut-off in which S corporation activity is taxed to those who owned the stock on a particular date rather than pro-rata, per-share, per-day,[6561] whereas such a cut-off may very well be available for a partnership interest.[6562] Thus, when a grantor trust owns S corporation stock, the grantor should consider turning off grantor trust status before January 1 of the year of sale if the grantor wants to avoid paying tax when the business is sold.

III.B.2.j.ii. Tax Allocations on the Transfer of Stock in an S Corporation

III.B.2.j.ii.(a). General Rules for Tax Allocations on the Transfer of Stock in an S Corporation

Although basis adjustments apply to partnership assets when a partnership interest is transferred in a taxable event or at a partner's death,[6563] similar adjustments do not apply to the corporation's assets when stock in an S corporation is transferred in a taxable event or at a shareholder's death. The basis adjustment might be replicated by liquidating the corporation, in which case the corporation is deemed to sell its assets,[6564] increasing the assets' basis. The shareholders are taxed on the sale of the assets. Then the shareholders will have a loss on liquidation to the extent that their basis, increased by death (or purchase, etc.) and increased by their K-1 income from the deemed sale of the corporation's assets, exceeds the fair market value of the assets distributed. In a perfect world, if the sole shareholder dies, the K-1 income will be offset by the shareholder's loss on liquidation. However, the nature of the K-1 income might not be a pure long-term capital gain, as depreciation recapture and the related party rules relating depreciable or amortizable property might apply.[6565] Furthermore, if the shareholder is a QSST, the gain on the deemed asset sale passes through to the beneficiary, whereas the loss is trapped in the trust;[6566] thus, where possible, liquidate the S corporation before funding a QSST after a basis-changing event.

[6560] If the grantor trust does not hold all of the stock that the grantor owns or is deemed to own, an accounting cut-off is not available at all; see part III.B.2.j.ii.(b) Transfer of Less Than Shareholder's Entire Interest. Even if does own all of that stock, an accounting cut-off still is not available; see fn. 6574, found in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

[6561] See generally part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[6562] See part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership, especially part III.B.2.j.iii.(e) Allocation of Specific Items, the latter which may require an accounting cut-off for various items.

[6563] See text accompanying footnotes 5370-5393 and 6616-5409.

[6564] Code § 336.

[6565] Code § 1239. Pay careful attention to the Code § 267 attribution rules and exceptions to those rules. Code § 267(c)(1) has more limited attribution when trusts are involved, so Code § 1239 is easier to avoid when the decedent passes assets in trust rather than outright. II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

[6566] Reg. § 1.1361-(j)(8) provides:

> Coordination with grantor trust rules. If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST

Below is a discussion of pro-rating income from the transfer of stock.[6567]

Big increases in income (such as from the sale of significant capital asset) toward the end of a taxable year can cause problems for a shareholder whose stock is transferred before the sale. The deadline for declaring a dividend is often 1-2 months after the record date, so that the transferring shareholder might not be eligible for the related tax distribution, even if the other shareholders would otherwise have agreed to use an earlier record date. One might consider requiring in the shareholders' agreement a requirement that an accounting cut-off be done so that the gain is allocated to the recipient shareholder and not the transferring shareholder.[6568] If the stock is held in trust before and after the transfer, the Uniform Principal and Income Act might remedy this mismatch.[6569]

III.B.2.j.ii.(b). Transfer of Less Than Shareholder's Entire Interest

A grantor who transfers only a portion of his or her interest in the S corporation has no choice of tax allocation method. The deemed transferor and transferee will be allocated a pro rata portion of S corporation items based upon a two-step process:[6570]

(1) each corporate item is assigned, in equal portion, to each day of the taxable year.

(2) that portion is divided pro rata among the shares outstanding on that day.

The grantor is treated as a shareholder for the day of disposition, including the day of his or her death.[6571]

III.B.2.j.ii.(c). Transfer of Shareholder's Entire Interest

When a grantor transfers the entire S corporation interest, he or she uses the daily proration rule of Code § 1377(a)(1) unless an election is made to apply the special rule of Code § 1377(a)(2), described below.

A grantor who terminates his or her entire interest, in conjunction with the remaining shareholders, may elect to terminate the corporation's tax year.[6572] Reg. § 1.1377-1(b)(4) provides that this election is available:[6573]

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distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.

[6567] See footnote 228 for a distribution method to take into account varying interests.

[6568] See text accompanying footnotes 6572-6582.

[6569] Section 506 of the Uniform Principal and Income Act. The Comments mention that QSSTs were considered when drafting Section 506(a)(3).

[6570] Code § 1377(a)(1).

[6571] Reg. § 1.1377-1(a)(2)(ii).

[6572] Code § 1377(a)(2).

[6573] Reg. § 1.1377-1(b)(4) also provides that, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

> on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder.

Reg. § 1.1377-1(a)(2)(iii), "Shareholder trust conversions," provides:[6574]

> If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

Reg. § 1.1377-1(a)(2)(iii) is illustrated in Reg. § 1.1377-1(c), Example (3), "Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT):"

> (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361-1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's pro rata share of S corporation's nonseparately computed income is $100,000.
>
> (ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is $49,727 ($100,000 x

[6574] T.D. 8994 explains:

> A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election….The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2)….When a trust changes from a wholly-owned grantor trust or QSST to an ESBT or from an ESBT to a QSST, the individuals who are shareholders of the S corporation under section 1361(c)(2)(B) remain the same. The election to terminate the taxable year provided in section 1377(a)(2) applies to the termination of a shareholder's interest in the S corporation. Accordingly, it is appropriate to treat the conversion of a trust described in section 1361(c)(2)(A)(ii) or (iii) to an ESBT or QSST as a termination of the prior trust's interest in the S corporation, but not to treat other conversions to an ESBT or QSST as terminations. The election under § 1.1368-1(g) is also not available because the conversion of the trust is not a qualifying disposition.

182 days/366 days), and the pro rata share of S corporation income allocated to the ESBT is $50,273 ($100,000 x 184 days/366 days).

For an example of how this could be disastrous, see the indented text accompanying fn. 6290 in part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation.

Query whether a cut-off applies when the deemed owner of a grantor trust dies:[6575]

- It is a conversion of a trust described in Code § 1361(c)(2)(A)(i) (a wholly owned grantor trust)[6576] to a trust described in Code § 1361(c)(2)(A)(ii) (a trust that was a wholly owned grantor trust immediately before the death of the deemed owner and which continues in existence after such death),[6577] so Reg. § 1.1377-1(a)(2)(iii) would seem to prohibit a cut-off. On the other hand, Reg. § 1.1377-1(b)(4) permits a cut-off when a shareholder dies. Generally, conflicting provisions are interpreted by giving effect to the one most tailored to the situation. Because the death of the deemed sole owner of a trust is just one of many ways to convert a grantor trust to a nongrantor trust, Reg. § 1.1377-1(b)(4) should control when conflicting with Reg. § 1.1377-1(a)(2)(iii). On the other hand, Reg. § 1.1377-1(a)(2)(iii) expressly contemplates a conversion to a trust described in Code § 1361(c)(2)(A)(ii), which can occur only when the deemed owner dies.

- Instinctively, most tax advisors would view applying Reg. § 1.1377-1(a)(2)(iii) to a revocable trust would be preposterous – they would argue that of course Reg. § 1.1377-1(b)(4) would control. But I'm not sure how they would get around the fact that Reg. § 1.1377-1(a)(2)(iii) expressly contemplates a conversion to a trust described in Code § 1361(c)(2)(A)(ii). To avoid this argument, have the (formerly) revocable trust elect income taxation as an estate,[6578] so that it is not taxed as a trust at all.[6579] Another option would be for the individual to hold the stock in his or her own name and do a nonprobate transfer via either the applicable state's nonprobate transfer statute or by ensuring that the stock is a "security" that can be transferred using the Uniform TOD Security Registration Act.[6580]

To effect this interim closing of the corporation's books, each of the affected shareholders and the corporation must consent to the election. An affected shareholder is defined as:[6581]

(1) the shareholder whose interest is terminated; and

(2) all shareholders to whom such shareholder has transferred shares during the taxable year (if such shareholder has transferred shares to the corporation, the

[6575] See part III.B.2.j.ii.(d) Death of a Shareholder.
[6576] See part III.A.3.b.i A Trust All of Which Is Treated Under the Grantor Trust Rules as Owned by An Individual Who Is a Citizen or Resident of the United States.
[6577] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[6578] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.
[6579] See fn 5666 in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[6580] For the latter, search https://www.uniformlaws.org/home. If the S corporation is an LLC, the operating agreement might provide for such a transfer on death, if allowed by state law (which generally would be the case).
[6581] Code § 1377(a)(2)(B).

affected shareholders include all persons who are shareholders during the taxable year).

Subsequently, the books will be treated as if the taxable year consisted of two taxable years, the first of which ends on the close of the day in which the grantor's entire interest in the S corporation is terminated.[6582]

However, the grantor probably will not be able or willing to divest himself or herself of his or her entire interest in the S corporation to effect this result. More likely, the grantor has structured the transfer so that he or she retains the voting shares of the company, while transferring the vast majority of corporate stock to the trust as non-voting shares. A conventional structure might have the grantor retaining 5% of the company shares as its only voting stock, while transferring 95% of the remaining non-voting stock to the trust. By terminating grantor trust status in such a situation, the grantor will not be able cut off his or her entire interest in the S corporation. Instead, the grantor should consider turning off the grantor trust powers before the tax year of sale to avoid this concern.

See part II.A.2.k Terminating an S Election regarding allocation of income between taxable periods when an S election terminates, which provides more liberal opportunities to do accounting cut-offs (but generally at a high tax cost).

III.B.2.j.ii.(d). Death of a Shareholder

The death of a shareholder (grantor) is treated as if the grantor had sold his or her entire interest in the S corporation. As such, the applicable tax allocation rules upon the death of the grantor are similar to those of a transfer of the entire interest, as enunciated above. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return,[6583] with the date of death being reported on the decedent shareholder's final individual income tax return.[6584] Items from the portion of the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.[6585]

If the stock is held in a revocable trust or an irrevocable grantor trust, see text accompanying fns 6576-6580 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

***General Rule (Default Rule)* — Daily Proration**

As above, the default rule of daily proration applies absent the corporation and shareholder's joint election for an interim closing of the books.

[6582] Reg. § 1.1377-1(b)(1).
[6583] Reg. § 1.1366-1(a)(1).
[6584] Reg. § 1.1377-1(a)(2)(ii) provides:

> *Determining shareholder for day of stock disposition*. A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

[6585] Senate Report, 1982 Subchapter S Revision Act, PL 97-354.

***Special Rule (By Agreement)* — Interim Closing of the Books**

The executor or administrator of the deceased grantor's estate may consent to the termination election on behalf of the deceased grantor and his estate.[6586] As before, all affected shareholders must consent to the election.

III.B.2.j.ii.(e). Change in Qualification of Trust to Hold S corporation Stock During Taxable Year

If, during an S corporation's taxable year, a trust that is an eligible shareholder of the S corporation converts from a trust described in Code § 1361(c)(2)(A)(i), (ii), (iii), or (v)[6587] for the first part of the year to a trust described in a different subpart of Code § 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts.[6588] This includes a trust that is an ESBT[6589] for part of the year and an eligible shareholder under Code § 1361(c)(2)(A)(i)-(iv) for the rest of the year.[6590]

The first day that a QSST[6591] or an ESBT is treated as an S corporation shareholder is the effective date of the QSST or ESBT election.[6592] Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest, unless the trust was a trust described in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death or III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It before the conversion.[6593]

III.B.2.j.ii.(f). Distribution after Transfer

Consider whether the donor or other transferor will need to receive distributions after the transfer and whether state law permits such transfers. For example, a shareholder might need a distribution to pay taxes but might not know how much until after the corporate income tax return for the year is filed.

State corporate law might impose time limits preventing distributions to shareholders more than a particular number of days after the record date.[6594] Using an LLC or other unincorporated entity for state law purposes might allow one to dispense with this limitation. Of course, the transferee could always agree to pay more to the transferor, but that imposes risk on the transferor with respect to the transferee's ability or willingness to perform.

6586 Reg. § 1.1377-1(b)(5)(ii).
6587 See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.
6588 Reg. § 1.1377-1(a)(2)(iii).
6589 See part III.A.3.e.ii Electing Small Business Trusts (ESBTs.
6590 Reg. § 1.1361-1(m)(3)(iv). Reg. § 1.641(c)-1(d)(2)(i) refers to Reg. § 1.1361-1(m)(3)(iv), which in turn refers to Reg. § 1.1377-1(a)(2)(iii).
6591 See part III.A.3.e.i QSSTs.
6592 Reg. § 1.1377-1(a)(2)(iii).
6593 Reg. § 1.1377-1(a)(2)(iii).
6594 See, *e.g.*, R.S.Mo. § 351.250.

One taxpayer argued that distributions the calendar year after her gave 95% of his stock should be applied against the basis of the donated stock, suggesting that the gift was not complete because that following calendar year he received distributions with respect to the donated stock, but the court didn't agree with his arguments.[6595]

III.B.2.j.iii. Tax Allocations upon Change of Interest in a Partnership

Special rules apply if a partnership interest is created by gift. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

For implementation of the rules set forth in this part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership, see part III.B.2.j.iii.(e) Allocation of Specific Items, which also applies in other situations.

Rev. Rul. 72-352 held that a trust's distribution of its partnership interest to the remainderman on the termination of the trust did not terminate the taxable year of the partnership but the taxable year of the partnership did close with respect to the trust in its capacity as partner, so that the trustees must include in the gross income of the trust its distributive share of the partnership items and any guaranteed payments as though the partnership year had ended on the trust's termination date. Consider that ruling in the context of the rest of part III.B.2.j.iii, which describes regulations adopted after that ruling but do not expressly refer to that ruling.

III.B.2.j.iii.(a). Transfer of Less Than a Partner's Entire Interest

Generally, the partnership's taxable year does not close with respect to a partner who sells or exchanges less than his entire interest or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise);[6596] even a transfer of a partner's entire interest by gift does not close the taxable year.[6597] However, the sale or exchange of at least 50% of a partnership terminates the partnership, closing the books,[6598]but a "sale or exchange" does not include the disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest;[6599] see part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership for other consequences of such a termination.

Subject to certain exceptions, if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year are determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.[6600] The exceptions are:

[6595] *Miller v. Commissioner*, T.C. Memo. 2011-189.
[6596] Code § 706(c)(2)(B); Reg. § 1.706-1(c)(3).
[6597] Reg. § 1.706-1(c)(5), which further provides that the income up to the date of gift attributable to the donor's interest shall be allocated to the donor under Code § 704(e)(2).
[6598] Reg. § 1.708-1(b)(3).
[6599] Reg. § 1.708-1(b)(2).
[6600] Code § 706(d)(1).

- If during any taxable year of the partnership any partner's interest changes, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item[6601] shall be determined:[6602]
    - by assigning the appropriate portion of such item to each day in the period to which it is attributable,[6603] and
    - by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.[6604]
- If during any taxable year of the partnership there is a change in any partner's interest in the partnership (the "upper tier partnership"), and such partnership is a partner in another partnership (the "lower tier partnership"), then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles described in fn. 6603) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.[6605]

III.B.2.j.iii.(b). Transfer of Partner's Entire Interest

The taxable year of a partnership closes "with respect to a partner whose entire interest terminates (whether by reason of death, liquidation or otherwise.)"[6606]

[6601] Code § 706(d)(2)(B) provides:

> For purposes of this paragraph, the term allocable cash basis item means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:
> (i) Interest.
> (ii) Taxes.
> (iii) Payments for services or for the use of property.
> (iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

[6602] Code § 706(d)(2)(A).

[6603] Code § 706(d)(2)(A)(i). Code § 706(d)(2)(C)(i) provides that, if any portion of any allocable cash basis item is attributable to any period before the beginning of the taxable year, such portion shall be assigned under this rule to the first day of the taxable year. Code § 706(d)(2)(D) provides that, if any portion of a deductible cash basis item is assigned under this rule to the first day of any taxable year, then such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and any amount allocated under this rule to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in Code § 755.
Code § 706(d)(2)(C)(ii) provides that, if any portion of any allocable cash basis item is attributable to any period after the close of the taxable year, such portion shall be assigned under this rule to the last day of the taxable year.

[6604] Code § 706(d)(2)(A)(ii).

[6605] Code § 706(d)(3).

[6606] Code § 706(c)(2)(A). See also part II.Q.8.e.i Distribution of Partnership Interests.

A partnership taxable year closes with respect to a partner:[6607]

- who sells or exchanges his entire interest in the partnership,[6608]
- whose entire interest in the partnership is liquidated, or
- who dies.

In such a case, the partner includes in the partner's taxable income for the partner's taxable year within or with which the partner's interest in the partnership ends the partner's distributive share of items described in Code § 702(a) and any guaranteed payments under Code § 707(c) for the partnership taxable year ending with the date of such termination.[6609]

The partnership's taxable year, with respect to the remaining partners, does not close, unless the partnership is otherwise terminated, such as under Code § 708(b), which used to provide that the sale or exchange of a partnership interest which, by itself or aggregated with sales or exchanges in the preceding 12 months, transfers an interest of 50% or more of the total partnership capital or profits will effectively terminate the partnership.[6610]

III.B.2.j.iii.(c). Death of a Partner — Treated Like a Transfer of a Partner's Entire Interest

The death of a partner is treated as if the partner had transferred his or her entire interest in the partnership. Previously, the deceased partner's estate received all of the deceased partner's income for the partnership taxable year in which the death occurred. This is no longer true, and the taxable year closes with respect to a partner whose entire interest in the partnership has terminated.[6611] Thus, the death of a partner is treated as a transfer of the deceased partner's entire partnership interest to his or her estate.

If the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest closes on the date of such sale or exchange, or the date of the completion of the liquidation.[6612]

[6607] Reg. § 1.706-1(c)(2)(i).

[6608] Note also that Reg. § 1.706-1(c)(2)(iii) provides:

> *Deemed dispositions*. A deemed disposition of the partner's interest pursuant to § 1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §§ 1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner), shall be treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

[6609] Reg. § 1.706-1(c)(2)(i). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

[6610] Reg. § 1.708-1(b)(3). See parts II.Q.8.e.i Distribution of Partnership Interests (when a distribution as a sale or exchange) and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[6611] Code § 706(c)(2)(A).

[6612] Reg. § 1.706-1(c)(2)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition. *Id.*

Reg. § 1.706-1(c)(2)(ii) provides an example:

> H is a partner of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 2016. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2016. Such distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership will close with respect to H on March 31, 2016, and H will include in his final return for his final taxable year (January 1, 2016, through March 31, 2016) his distributive share of partnership items for that period under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4. W will include in her return for the taxable year ending December 31, 2016, her distributive share of partnership items for the period of April 1, 2016, through December 31, 2016, under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4.

Note that a partner's death can trigger a basis increase – or reduction – in that partner's share of the partnership's assets.[6613] Even absent a Code § 754 election, the possibility of reduction requires monitoring to make sure that the partnership's assets do not have a substantial built-in loss.[6614]

III.B.2.j.iii.(d). Other Occasions Calling for an Interim Closing of the Books

Because determination of the adjusted basis and fair market value is necessary to comply with Code § 755 allocations, a Code § 754 election[6615] by the partnership to adjust the basis of partnership assets for the benefit of a transferee partner[6616] or in the case of a liquidation[6617] will require an interim closing of the books.

Applying Code § 732(d) basis adjustments on distributions[6618] and Code § 708(b) partnership terminations[6619] might also require interim closings.

III.B.2.j.iii.(e). Allocation of Specific Items

The rules of this part III.B.2.j.iii.(e) apply for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership[6620] or if a partner sells or exchanges a part of his interest in a partnership or if the interest of a partner is reduced[6621]

[6613] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[6614] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[6615] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[6616] Code § 743(b).

[6617] Code § 734(b).

[6618] See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[6619] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

[6620] As described in Reg. § 1.706-1(c)(2) and (3).

[6621] As described in Reg. § 1.706-1(c)(3), including by the entry of a new partner.

(collectively, a "variation").[6622] However, they do not override certain other provisions.[6623] In all cases, all partnership items for each taxable year must be allocated among the partners, and no partnership items may be duplicated, regardless of the particular provisions that apply and regardless of the method or convention adopted by the partnership.[6624]

In allocating items, a partnership must take the following steps in the order indicated:[6625]

1. Determine whether certain additional exceptions apply:[6626]

    - This general rule will not preclude changes in the allocations among contemporaneous partners for the entire partnership taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment), if any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and the allocations resulting from the modification satisfy the provisions of Code § 704(b) and the regulations promulgated thereunder.[6627]

    - With respect to any taxable year in which there is a change in any partner's interest in a partnership for which capital is not a material income-producing factor, the partnership and such partner may choose to determine the partner's distributive share of partnership income, gain, loss, deduction, and credit using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year provided that the allocations satisfy the provisions of Code § 704(b).[6628]

[6622] Reg. § 1.706-4(a)(1).

[6623] Reg. § 1.706-4(a)(2) provides:

> Items subject to allocation under other rules, including sections 108(e)(8) and 108(i) (which provide special allocation rules for certain items from the discharge or retirement of indebtedness section), section 704(c) (relating to allocations with respect to certain contributed property), § 1.704-3(a)(6) (relating to allocations with respect to revalued property), section 706(d)(2) (relating to the determination of partners' distributive shares of allocable cash basis items), and section 706(d)(3) (relating the determination of partners' distributive share of any item of an upper tier partnership attributable to a lower tier partnership), are not subject to the rules of this section. In addition, the rules of this section do not apply in making allocation of book items pursuant to § 1.704-1(b)(2)(iv)(e), (f), or (s).

[6624] Reg. § 1.706-4(a)(2).

[6625] Reg. § 1.706-4(a)(3).

[6626] Reg. § 1.706-4(a)(3)(i), referring to Reg. § 1.706-4(b).

[6627] Reg. § 1.706-4(b)(1).

[6628] Reg. § 1.706-4(b)(2). Whether capital is a material income-producing factor might have changed since the regulation was promulgated by T.D. 9728 on July 31, 2015. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

2. Determine which of its items are subject to allocation under certain special rules for extraordinary items, and allocate those items accordingly.[6629] Subject to a small item exception,[6630] extraordinary items that may not be prorated[6631] include:[6632]

   - Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset;[6633]

   - Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business;[6634]

   - Any item from the disposition or abandonment of certain assets excluded from the definition of capital asset[6635] if substantially all the assets in the same category from the

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[6629] Reg. § 1.706-4(a)(3)(ii), referring to Reg. § 1.706-4(e).

[6630] Reg. § 1.706-4(e)(3) provides:

> *Small item exception*. A partnership may treat an item described in paragraph (e)(2) of this section as other than an extraordinary item for purposes of this paragraph (e) if, for the partnership's taxable year the total of all items in the particular class of extraordinary items (as enumerated in paragraphs (e)(2)(i) through (xi) of this section, for example, all tort or similar liabilities, but in no event counting an extraordinary item more than once) is less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items; and the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

[6631] Reg. § 1.706-4(e)(1), which provides:

> The partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred, regardless of the method (interim closing or proration method) and convention (daily, semi-monthly, or monthly) otherwise used by the partnership. These rules require the allocation of extraordinary items as an exception to the proration method, which would otherwise ratably allocate the extraordinary items across the segment, and the conventions, which could otherwise inappropriately shift extraordinary items between a transferor and transferee. However, publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships may, but are not required to, apply their selected convention in determining who held publicly traded units (as described in § 1.7704-1(b) or (c)(1)) at the time of the occurrence of an extraordinary item. Extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

[6632] Reg. § 1.706-4(e)(2).

[6633] As defined in Code § 1221 (determined without the application of any other rules of law). Reg. § 1.706-4(e)(2). Real estate might or might not constitute inventory. See part II.G.14 Future Development of Real Estate, especially fn. 1536.

[6634] As defined in Code § 1231(b) (determined without the application of any holding period requirement). Reg. § 1.706-4(e)(2)(ii).

[6635] Referring to the following provisions in Code § 1221(a):

> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) [excluded from this list]

same trade or business are disposed of or abandoned in one transaction (or series of related transactions);[6636]

- Any item from assets disposed of in an applicable asset acquisition;[6637]

- Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;[6638]

- Any item from the discharge or retirement of indebtedness (except items subject to special allocation rules provided in Code § 108(e)(8) and (i));[6639]

- Any item from the settlement of a tort or similar third-party liability or payment of a judgment;[6640]

- Any credit, to the extent it arises from activities or items that are not ratably allocated;[6641]

- For all partnerships, any additional item if, the partners agree[6642] to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for Code § 179 expenses);[6643]

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(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by-
  (A) a taxpayer whose personal efforts created such property,
  (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
  (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);
(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by-
  (A) a taxpayer who so received such publication, or
  (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

[remaining provisions of Code § 1221(a) are excluded from this list.]

[6636] Reg. § 1.706-4(e)(2)(iii).
[6637] Reg. § 1.706-4(e)(2)(iv), referring to Code § 1060(c).
[6638] Reg. § 1.706-4(e)(2)(v).
[6639] Reg. § 1.706-4(e)(2)(vi).
[6640] Reg. § 1.706-4(e)(2)(vii).
[6641] Reg. § 1.706-4(e)(2)(viii), giving as an example the Code § 47 rehabilitation credit, which is based on placement in service.
[6642] Within the meaning of Reg. § 1.706-4(f) ; see fns. 6670-6673.
[6643] Reg. § 1.706-4(e)(2)(ix).

- Any item which, in the IRS' opinion, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included;[6644]

- Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.[6645]

3. Determine with respect to each variation whether it will apply the interim closing method or the proration method.[6646] Absent an agreement of the partners[6647] to use the proration method, the partnership must use the interim closing method.[6648] The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the IRS may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.[6649]

4. Determine when each variation is deemed to have occurred under the partnership's selected convention (generally, daily, semi-monthly, or monthly).[6650]

5. Determine whether there is an agreement of the partners[6651] to perform regular monthly or semi-monthly interim closings.[6652] If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform semi-monthly

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[6644] Reg. § 1.706-4(e)(2)(x).
[6645] Reg. § 1.706-4(e)(2)(xi).
[6646] Reg. § 1.706-4(a)(3)(iii).
[6647] Within the meaning of Reg. § 1.706-4(f); see fns. 6670-6673.
[6648] Reg. § 1.706-4(a)(3)(iii).
[6649] Reg. § 1.706-4(a)(3)(iii).
[6650] Reg. § 1.706-4(a)(3)(iv), referring to the selected convention under Reg. § 1.706-4(c). However, all variations within a taxable year shall be deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, for a calendar year partnership applying either the semi-monthly or monthly convention to a variation occurring on January 1st through January 15th, the variation will be deemed to occur at the beginning of the day on January 1st. Reg. § 1.706-4(c)(2)(i). Also, if a person becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, if both such variations would be deemed to occur at the same time under the rules of Reg. § 1.706-4(c)(1), then the variations with respect to that partner's interest will instead be treated as occurring on the dates each variation actually occurred. Reg. § 1.706-4(c)(2)(ii). Thus, the partnership must treat such a person as a partner for the entire portion of its taxable year during which the partner actually owned an interest; see Reg. § 1.706-4(c)(4), Example (2). However, Reg. § 1.706-4(c)(2)(ii) (by its own terms) does not apply to publicly traded partnerships (as defined in Code § 7704(b)) that are treated as partnerships with respect to holders of publicly traded units (as described in Reg. § 1.7704-1(b) or 1.7704-1(c)(1)).
[6651] Within the meaning of Reg. § 1.706-4(f); see fns. 6670-6673.
[6652] Reg. § 1.706-4(a)(3)(v), referring to closings under Reg. § 1.706-4(d). Reg. § 1.706-4(d)(1) provides:

> *Optional regular monthly or semi-monthly interim closings*. Under the rules of this section, a partnership is not required to perform an interim closing of its books except at the time of any variation for which the partnership uses the interim closing method (taking into account the applicable convention). However, a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) perform regular monthly or semi-monthly interim closings of its books, regardless of whether any variation occurs. Regardless of whether the partners agree to perform these regular interim closings, the partnership must continue to apply the interim closing or proration method to its variations according to the rules of this section.

For a discussion of Reg. § 1.706-4(f) referred to above, see fns. 6670-6673.
Reg. § 1.706-4(d)(2) provides an example of the principles of Reg. § 1.706-4(d)(1).

closings), regardless of whether any variation occurs.[6653] Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.[6654]

6. Determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books.[6655] The first segment starts with the beginning of the taxable year of the partnership and ends at the time of the first interim closing.[6656] Any additional segment begins immediately after the closing of the prior segment and ends at the time of the next interim closing.[6657] However, the last segment of the partnership's taxable year must end no later than the close of the last day of the partnership's taxable year.[6658] If no interim closings occur, the partnership has one segment, which corresponds to its entire taxable year.[6659]

7. Apportion the partnership's items for the year among its segments.[6660] The partnership determines the items of income, gain, loss, deduction, and credit of the partnership for each segment.[6661] Generally, a partnership treats each segment as though the segment were a separate distributive share period.[6662] For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will apply based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year.[6663]

8. Determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method.[6664] The first proration period in each segment begins at the beginning of the segment and ends at the first time of the first variation within the segment for which the partnership selects the proration method.[6665] The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnership selects the proration method.[6666] However, each proration period ends no later than the close of the segment.[6667]

[6653] Reg. § 1.706-4(a)(3)(v).
[6654] Reg. § 1.706-4(a)(3)(v).
[6655] Reg. § 1.706-4(a)(3)(vi).
[6656] Reg. § 1.706-4(a)(3)(vi).
[6657] Reg. § 1.706-4(a)(3)(vi).
[6658] Reg. § 1.706-4(a)(3)(vi).
[6659] Reg. § 1.706-4(a)(3)(vi).
[6660] Reg. § 1.706-4(a)(3)(vii).
[6661] Reg. § 1.706-4(a)(3)(vii).
[6662] Reg. § 1.706-4(a)(3)(vii). For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. Reg. § 1.706-4(a)(3)(vii).
[6663] Reg. § 1.706-4(a)(3)(vii). For example, the expenses related to the election to expense a Code § 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method. Reg. § 1.706-4(a)(3)(vii).
[6664] Reg. § 1.706-4(a)(3)(viii).
[6665] Reg. § 1.706-4(a)(3)(viii).
[6666] Reg. § 1.706-4(a)(3)(viii).
[6667] Reg. § 1.706-4(a)(3)(viii).

9. Prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.[6668]

10. Determine the partners' distributive shares of partnership items by taking into account the partners' interests in such items during each segment and proration period.[6669]

Various provisions above refer to agreements by the partners.[6670] "Agreement of the partners" refers to:

- An agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records,[6671] or

- A selection of the method, convention, or extraordinary item made by a person authorized to make that selection,[6672] if that person's selection is in a dated, written statement maintained with the partnership's books and records.[6673]

In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

As mentioned in fn. 6623, a special rule for determining a partner's share of the partnership's allocable cash-basis items also applies.[6674] Each partner's distributive share of any allocable cash basis items shall be determined:[6675]

(1) by assigning the appropriate portion of such items to each day in the period to which it is attributable; and

(2) by allocating the portion assigned to any such day among the partners in proportion to their partnership interests at the close of such day.

Also, the modified accrual method must be applied with respect to the following allocable cash basis items, as paid or received by the partnership:[6676]

(1) interest; or

(2) taxes; or

(3) payments for services or for the use of property (for example, rent); or

[6668] Reg. § 1.706-4(a)(3)(ix).
[6669] Reg. § 1.706-4(a)(3)(x).
[6670] Reg. § 1.706-4(f) refers to Reg. § 1.706-4(a)(3)(iii) (relating to selection of the proration method), Reg. § 1.706-4(c)(3) (relating to selection of the semi-monthly or monthly convention), Reg. § 1.706-4(d) (relating to performance of regular monthly or semi-monthly interim closings), and Reg. § 1.706-4(e)(2)(ix) (relating to selection of additional extraordinary items).
[6671] One example is a selection that is included in the partnership agreement.
[6672] This might be under a grant of general authority provided for by state law or in the partnership agreement.
[6673] Reg. § 1.706-4(f).
[6674] Code § 706(d)(2).
[6675] Code § 706(d).
[6676] Code § 706(d)(2)(B)(i-iv).

(4) any other item specified by regulations.

III.B.2.j.iv. Income Tax Reimbursement Clause

III.B.2.j.iv.(a). Grantor Trust Reimbursing for Tax Paid by the Deemed Owner

I usually include a clause providing that the trust cannot reimburse the grantor, to avoid a possible argument that the grantor has an equitable right to be reimbursed that may be included in the grantor's estate for estate tax purposes. The Uniform Trust Decanting Act[6677] suggests that decanting[6678] may allow a trust to be switched from grantor trust to nongrantor trust or vice versa.[6679]

If the grantor cannot achieve accounting cut off or cannot terminate his grantor trust powers to escape the dire tax consequences of an exploding GRAT or irrevocable grantor trust, an income tax reimbursement clause may be a valuable tool to remedy this problem. In its simplest form, the income tax reimbursement clause authorizes the trustee with a discretionary power to reimburse the grantor for income taxes incurred in excess of the annuity or note payments.

An income tax reimbursement provision will cause inclusion of the trust assets in the grantor's gross estate if it constitutes a transfer with a retained life estate interest in the trust assets.[6680] Any retention of a right to apply the trust property towards the discharge of a legal obligation

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[6677] As adopted July 2015. See http://www.uniformlaws.org/Act.aspx?title=Trust Decanting.

[6678] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

[6679] Section 19(b)(9) provides:

> Subject to paragraph (4):
>
> (A) except as otherwise provided in paragraph (7), the second trust may be a nongrantor trust, even if the first trust is a grantor trust; and
>
> (B) except as otherwise provided in paragraph (10), the second trust may be a grantor trust, even if the first trust is a nongrantor trust.

Section 19(b)(4) prohibits decanting that would mess up an S election. For example, I do not believe that a QSST's S corporation stock can be transferred into another trust by decanting, but the Act authorizes decanting to take the form of a trust amendment without actually transferring the stock, which may be permissible by a QSST, depending on the amendment. See part III.A.3.e.i.(a) QSSTs Generally, especially fn 5727.

Section 19(b)(7) protects grantor trust status under Code § 672(f)(2)(A), which describes the conditions under which the grantor trust rules treat a nonresident alien as a deemed owner.

Section 19(b)(10) provides:

> An authorized fiduciary may not exercise the decanting power if a settlor objects in a signed record delivered to the fiduciary within the notice period and:
>
> (A) the first trust and a second trust are both grantor trusts, in whole or in part, the first trust grants the settlor or another person the power to cause the first trust to cease to be a grantor trust, and the second trust does not grant an equivalent power to the settlor or other person; or
>
> (B) the first trust is a nongrantor trust and a second trust is a grantor trust, in whole or in part, with respect to the settlor, unless:
>
> > (i) the settlor has the power at all times to cause the second trust to cease to be a grantor trust; or
> >
> > (ii) the first-trust instrument contains a provision granting the settlor or another person a power that would cause the first trust to cease to be a grantor trust and the second-trust instrument contains the same provision.

[6680] Code § 2036(a). The right to be reimbursed for tax liability over the annuity or note amount, presumably, could be deemed as the possession or enjoyment of, or the right to the income from, the property or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

causes inclusion under Code § 2036[6681] and, if the right is absolute, Code § 2041. GRATs should include income tax reimbursement clauses, which potentially makes them includible in the grantor's gross estate. Often, this is not a concern, because GRATs are often fully included in the grantor's estate if the grantor dies during the annuity term. However, in the case of a sale to the irrevocable grantor trust, only the note is included under Code § 2036; therefore, avoiding estate inclusion due to tax reimbursement clauses is particularly important.

Rev. Rul. 2004-64 provides specific guidance on this point.[6682] When trust language provides an unrelated trustee[6683] discretionary power to reimburse the grantor for excess income taxes, the reimbursement clause will not necessarily cause estate inclusion, if there is no understanding that the trustee will reimburse the grantor.[6684] Subsequent rulings discussing tax reimbursement clauses include:

- In Letter Ruling 200822008, the trust was to be modified authorizing the trustee "to pay to the Grantor or the Grantor's legal representative those amounts sufficient to satisfy the Grantor's federal, state, or local income tax liability actually incurred by the Grantor attributable to the 'pass through' of the Trust's taxable income." Such distributions would be subject to the consent of an independent "Reimbursement Committee"[6685] and an adult child who qualifies

[6681] Reg. § 20.2036-1(b)(2). The grantor is legally obligated to pay his or her income taxes, thus any right to reimbursement for this legal obligation may be included in the grantor's gross estate.

[6682] See also Forsberg & Worthington, Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them, *Probate & Property*, Vol. 19, No. 3, May/June 2005.

[6683] Rev. Rul. 2004-64 includes in its facts, "The governing instrument of Trust requires that the trustee be a person not related or subordinate to [the grantor] within the meaning of § 672(c) of the Internal Revenue Code.

[6684] Rev. Rul. 2004-64, Situation 3. See Letter Ruling 201647001, described in fn. 6697.

[6685] The ruling included the following details:

> The initial member of the Reimbursement Committee will be A. It is represented that A is neither an employee of Grantor, nor an employee of a corporation whose stock is owned by the Grantor (or Trust, Exempt Trust or Non-Exempt Trust) or whose executives include Grantor, nor a relative of the Grantor listed in section 672(c). Spouse, if she is then living, otherwise Grantor's living children by majority vote, or if there are no then living children of Grantor, then Grantor's living issue (by majority vote) may remove any persons then serving on the Reimbursement Committee, and or appoint additional persons at any time with or without cause. However, no one related or subordinate to the Grantor within the meaning of § 672(c), can be appointed to the Reimbursement Committee.

The ruling elaborated on A's relationship:

> In addition, because A's only relationship to the Grantor presumably is that of the Grantor's independent attorney, A also does not meet the definition of a related or subordinate party under § 672(c). Accordingly, the Reimbursement Committee consisting of A will not be considered a related or subordinate party within the meaning of § 672(c).

as a Code § 672(c) adverse party; including the child seems unnecessary[6686] and potentially harmful, given that a child who is an adverse party may make a taxable gift by consenting.[6687]

- In Letter Ruling 200944002, instead of providing an income tax reimbursement right,[6688] the trust authorized distributions to the grantor, among other beneficiaries, in the trustee's sole and absolute discretion.[6689] The trustee was independent.[6690] State law respected spendthrift

[6686] The ruling noted:

> Under the terms of the provision, a consenting child beneficiary must be an adverse party; therefore, such a child beneficiary does not meet the definition of a related or subordinate party under § 672(c). Accordingly, a consenting child beneficiary will not be considered a related or subordinate party within the meaning of § 672(c). We note that this conclusion does not require us to address whether the beneficiary children of the Grantor are in fact adverse parties (and if they are, to what extent, *i.e.*, part or all of the Trust), because the Reimbursement Provision requires a child beneficiary be an adverse party.

[6687] To be an adverse party, the child must have "a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust." See part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status, especially the text accompanying fns. 6406-6412. By negative implication, Reg. § 25.2511-1(g)(1) suggests the possibility that a trustee's decision to make distributions may be a gift if the trustee is a beneficiary: "A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee…." Reg. § 25.2511-1(g)(2) elaborates - see text accompanying fn 2384 in part II.J.2.b **Trust** Provisions Authorizing Distributions. See also Reg. § 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2043 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap).

Without suggesting whether or not the tax reimbursement clause fits this exception, I would prefer to avoid the issue.

[6688] The trust agreement "provides that trustee shall not pay Grantor or Grantor's executors any income or principal of Trust in discharge of Grantor's income tax liability." See text accompanying fn. 6699.

[6689] The trust provided that:

> trustee will pay over the income and principal of Trust in such amounts and proportions as trustee in its sole and absolute discretion may determine for the benefit of one or more members of the class consisting of Grantor, Grantor's spouse and Grantor's descendants.

[6690] The trust provided that:

> the following persons may not be a trustee of Trust or any other trust created under trust: (1) Grantor; (2) the spouse or a former spouse of Grantor; (3) any individual who is a beneficiary of Trust or a trust created under Trust; (4) the spouse or a former spouse of a beneficiary of any trust hereunder; (5) anyone who is related or subordinate to Grantor within the meaning of § 672(c).

provisions regarding the settlor.[6691] The ruling held no Code § 2036 inclusion so long as no pre-arrangement regarding distributions to the settlor.[6692]

- Letter Ruling 201647001 approved modifying a trust to authorize independent trustees[6693] to reimburse income tax[6694] when, due to "unforeseen and unanticipated circumstances," the

[6691] The ruling described applicable state law:

State Statute provides that a person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust, may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. Under State Statute, if the trust instrument contains this transfer restriction, it prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor, from satisfying a claim out of the beneficiary's interest in the trust unless, (1) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (2) the settlor intends to defraud a creditor by transferring the assets to the trust;(3) the settlor is currently in default of a child support obligation by more than 30 days; or (4) the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor.

[6692] After citing the non-reimbursement clause in fn. 6688, the ruling reasoned and held:

Although Rev. Rul. 2004-64 does not consider this situation, it is clear from the analysis, that because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, that Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under § 2036. See Rev. Rul. 2004-64. In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036.

We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.

[6693] The ruling analyzed the trustee provisions:

Trust prohibits Grantors from serving as trustees of Trust and any trusts created thereunder. However, pursuant to the modifications to Article 8 of Trust, Grantors will retain the power to remove and replace the Trustees, including the Independent Trustee. However, any successor Independent Trustee appointed by Grantors cannot be related or subordinate within the meaning of § 672(c) to the Grantors. Accordingly, under Rev. Rul. 95-58, Grantor's retained removal and replacement powers are not considered the reservation of the Independent Trustee's powers for purposes of § 2038. Further, the Family Trustees do not possess any powers to distribute income or corpus to the Trust beneficiaries. Therefore, Grantors' powers to remove and replace the Family Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038. Accordingly, we conclude that the modifications to Article 8 which grants Grantors the power to remove and replace the Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038.

[6694] The modification included:

Section 13.3(b) is modified to include a tax reimbursement clause requiring compliance with Situation 3 of Rev. Rul. 2004-64, 2004-2 C.B. 7. Specifically, Section 13.3(b), as modified, provides that Grantors shall not be entitled to any right of reimbursement under any applicable law for their tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to either Grantor under §§ 671 through 679. If in any calendar year, a trust created hereunder is treated as a "grantor trust" as to either Grantor under §§ 671 through 679, an Independent Trustee may from time to time, distribute to a Grantor so much of the income or principal of the trust as may be sufficient to satisfy all or part of such Grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in such Grantor's taxable grantors' payment of income tax had become "unduly burdensome." Letter Ruling 201647001 held that the children did not make a gift when the trust was modified, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust, meaning the changes did not constitute a gift[6695] and did not cause it to lose its zero inclusion ratio for GST purposes.[6696] Subject to qualifications regarding any prearrangement, the ruling held no inclusion in the grantors' estates.[6697] (Note

income in excess of the amount of such taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of such Grantor's income tax liability.

[6695] "The proposed modifications to Articles 5, 6, 9, 12, and 13 are administrative in nature and do not result in a change in beneficial interests in Trust. We conclude that these modifications do not result in a deemed transfer by any of the children for purposes of § 2501."

[6696] The ruling reasoned and held:

In the instant case, Trust became irrevocable after September 25, 1985. It is represented that sufficient GST exemption was allocated to Trust so that Trust has an inclusion ratio of zero under § 2642. No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.

Article 5.1 is modified only to the extent to provide that the modification to Trust may not extend the term of any trust created under Trust. Under Rulings 2 and 4, we concluded that the proposed modifications to do not constitute the release, exercise, or lapse of powers of appointment for purposes of §§ 2041 and 2514. Accordingly, the proposed modifications do not constitute constructive additions to Trust. The modifications were effected in accordance with state law and pertain to the administration of Trust.

Accordingly, the proposed modifications to Articles 5, 6, 8, 9, 12, and 13 of Trust are administrative in nature and under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust. See Example 10 of § 26.2601-1(b)(4)(i)(E).

Therefore, based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause Trust, as modified, to lose its zero inclusion ratio for GST tax purposes under chapter 13.

[6697] The ruling reasoned and held:

In this case, under the terms of Section 13.3(b), as proposed, the Independent Trustee will have the discretion to reimburse either Grantor with respect to the income tax liability actually incurred by the Grantor attributable to Trust items, for periods after the Trust instrument is modified. Only a Trustee who is not related or subordinate to either Grantor, within the meaning of § 672(c) may exercise the powers to reimburse either Grantor. Accordingly, assuming there is no understanding, express or implied, between either Grantor and the Independent Trustee regarding the Independent Trustee's exercise of discretion, the Independent Trustee's discretion to satisfy either of the Grantor's obligation would not alone cause the inclusion of the trust in either of the Grantor's gross estate for federal estate tax purposes. However, as noted in Rev. Rul. 2004-64, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between either of the Grantor and the Independent Trustee regarding the Independent Trustee's exercise of this discretion; a power retained by either Grantor to remove the trustee and name the grantor as successor trustee; or applicable local law subjecting the trust assets to the claims of either of the Grantor's creditors) may cause inclusion of Trust's assets in either of the Grantor's gross estate for federal estate tax purposes.

Based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause the property of Trust to be included in the gross estate of either Grantor for federal estate tax purposes.

that, if the trustee mistakenly taxes the sale to a beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[6698])

However, if the grantor has an enforceable right to reimbursement, the reimbursement right will cause estate inclusion.[6699] Furthermore, applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust in the grantor's gross estate.[6700] This raises the issue of whether or not the availability of self-settled trusts (spendthrift trusts in which the grantor is the beneficiary) to the grantor's creditors subjects the trust to inclusion under Code § 2036.

The general rule is that the grantor's creditors can require distribution of self-settled trust assets to the extent which the trustee had discretion to make distributions.[6701] To the extent creditors can reach a self-settled trust, they are generally includible under Code § 2036 or an incomplete gift due to the grantor's retained power to terminate the trust by consigning his or her creditors to the trust assets.[6702] However, some states permit self-settled trusts to be protected from the grantor's creditors generally[6703] and some states only with respect to reimbursing taxes.[6704]

The Bankruptcy Abuse and Prevention Act of 2005, however, causes some concern about how well domestic asset protection trusts ("DAPTs") prevent creditors from gaining access to trust assets. Of particular concern is the 10-year lookback provision, which states that transfers to self-settled trusts by the debtor in which the debtor is a beneficiary of the trust within ten years before filing for bankruptcy.[6705] However, the language of the Act included a scienter requirement indicating that the grantor, by means of the transfer, intended to hinder, delay, or defraud any party to which the debtor was indebted.[6706] In other words, the burden would lay on the bankruptcy trustee to show that the filer had the necessary fraudulent intent. Thus, DAPTs formed for legitimate purposes, such as transfer tax minimization, will retain their usefulness as estate planning tools.[6707] However, at least one commentator has noted that it would be difficult for a filer to argue that the transfer of assets to a DAPT was not intended to delay or hinder a creditor.[6708] As such, some uncertainty remains as to whether a grantor will be required to wait the full ten years before the hole in the DAPT is plugged so that creditors will be unable to reach the trust assets. With this lingering uncertainty about the 2005 Act, it will be difficult for practitioners to definitively say that these self-settled trusts are free from creditor claims, and

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[6698] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the , especially fn. 2785.
[6699] Rev. Rul. 2004-64, Situation 2.
[6700] Rev. Rul. 2004-64, Situation 3.
[6701] Rev. Rul. 76-103; Forsberg & Worthington, Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them, *Probate & Property*, Vol. 19, No. 3, May/June 2005, note 27 at 7 (citing 2A Austin W. Scott, *Trusts* § 156).
[6702] Rev. Rul. 76-103; Code § 2038(a)(1).
[6703] See "Comparison of the Domestic Asset Protection Statutes," edited by David G. Shaftel and available to ACTEC Fellows on the State Surveys page at http://www.actec.org/resources/state-surveys.
[6704] See, *e.g.*, Texas Trust Code § 112.035(d)(1) (see Thompson Coburn LLP doc. no. 6599538).
[6705] 11 U.S.C. § 548(e)(1)(A-C).
[6706] 11 U.S.C. § 548(e)(1)(D).
[6707] Shaftel & Bundy, D.A.P.T. 2005: The Report of My Death Was an Exaggeration, *Steve Leimberg's Asset Protection Planning Newsletter* #68 (May 23, 2005), available at http://www.leimbergservices.com.
[6708] Jay Adkisson & Chris Reiser, Bankruptcy Act Impact on Life Insurance and Domestic Asset Protection Trusts, *Steve Leimberg's Asset Protection Planning Newsletter* #66 (May 3, 2005), available at http://www.leimbergservices.com.

subsequently, not includible in the grantor's gross estate. Keep that in mind when considering using a tax reimbursement clause.

If the grantor is concerned about being able to pay the income tax and cannot structure the trust to allow the grantor to turn off grantor trust status, the grantor should consider retaining a sizable portion of the asset being transferred. That retention may frustrate the grantor's goal of minimizing estate tax, but the grantor needs to be able to sleep at night.

III.B.2.j.iv.(b). Tax Distributions from Partnerships and S Corporations after Termination of Interest

Partnerships and S corporations typically make distributions to pay their owners' taxes. Usually these consist of just enough to their quarterly estimated tax payments, followed by a distribution the following March or April so that their owners can pay any balance due on undistributed income, to the extent not covered by the distributions to make the required quarterly estimated tax payments.

This practice causes certain issues to arise when an interest terminates before distributions are made to pay all of the tax incurred on income earned before termination. Language to address this issue is included in part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.